A Year in Review:
Regulatory Developments, Enforcement Actions and Lawsuits
Affecting Registered Investment Companies,
their Boards of Directors, and Investment Advisers

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ABA Business Law Section Meeting, Washington, DC
“Current Issues in Investment Management: Discussion with the SEC Staff”
CLE Panel
November 16, 2018
This memorandum summarizes regulatory developments, enforcement actions and lawsuits affecting registered investment companies, their boards of directors, and investment advisers over the last year. Section I provides a summary of recent regulatory and related developments. Section II provides a summary of recent enforcement actions and other court proceedings.

I. Recent Regulatory and Related Developments

A. SEC Staff Issues No-Action Letter Related Board Findings With Respect to Certain Affiliated Transactions

On October 12, 2018, the SEC staff issued a no-action letter to the Independent Directors Council regarding the fund board findings required by:

- Rule 10f-3 under the Investment Company Act of 1940, as amended ("1940 Act"), which provides exemptive relief for securities purchased during an underwriting wherein an affiliated person is a member of the underwriting syndicate, subject to certain conditions.

- Rule 17a-7, which provides exemptive relief for purchases and sales of securities between an investment company and certain affiliated persons, subject to certain conditions.

- Rule 17e-1, which provides a safe harbor from Section 17(e)(2)(A) of the 1940 Act, which prohibits a broker from receiving a commission, fee or other remuneration from an affiliated fund in excess of the usual and customary broker’s commission, subject to certain conditions.

Each of these rules explicitly states that, in order to rely on the rule, a fund board must adopt procedures reasonably designed to comply with the rule, make and approve changes to those procedures as the board deems necessary, and determine no less than quarterly that all transactions for the preceding quarter were effected in compliance with those procedures. The SEC no-action letter, however, states that the SEC staff will not recommend enforcement action to the SEC for violations of Rules 10f-3, 17a-7 or 17e-1 "if a fund’s board of directors receives, no less than quarterly, a written representation from the chief compliance officer that transactions in reliance on [the rules] complied with the procedures adopted by the board pursuant to the relevant [rule], instead of the board itself determining compliance." In its letter, the SEC noted that its position does "not change the board’s oversight role with respect to a fund’s overall compliance program," but allows “boards to avoid duplicating certain functions commonly performed by, or under the supervision
of, the CCO." See attached K&L Gates US Investment Management Alert, dated November 1, 2018.

B. **SEC Releases New Strategic Plan**

On October 11, 2018, the SEC released its new strategic plan that will guide the SEC's work over the next four years. The three goals laid out in the strategic plan are:

- Focusing on the long-term interests of Main Street investors, including by enhancing the SEC's understanding of retail and institutional investor channels, enhancing outreach and education efforts, pursuing enforcement and examination initiatives focused on misconduct that impacts retail investors, modernizing the design, delivery and content of disclosure, and identifying ways to increase the number and range of long-term and cost-effective investment options available to retail investors.

- Recognizing significant developments and trends in the capital markets and adjusting the SEC's efforts to effectively allocate resources, including by expanding the SEC's market knowledge and oversight capabilities, addressing existing SEC rules and approaches that are outdated, examining the SEC's cyber and other infrastructure strategies and promoting agency preparedness and emergency response capabilities.

- Elevating the SEC's performance by enhancing its analytical capabilities and human capital development, including by expanding the SEC's use of risk and data analytics, enhancing the SEC's internal control and risk management capabilities and promoting collaboration within and across SEC offices.

C. **SEC Chairman Clayton Issues Statement Regarding SEC Staff Views**

On September 13, 2018, SEC Chairman Jay Clayton issued a public statement regarding SEC staff views and communications. He noted that the SEC staff frequently offers guidance and makes their views known through communications such as written statements, compliance guides, letters, speeches, responses to frequently asked questions and responses to specific requests. He reminded industry participants, however, that SEC staff statements are not binding and create no enforceable legal rights or obligations. In this connection, Chairman Clayton stated that he had recently instructed the directors of the SEC's Division of Enforcement and the Office of Compliance Inspections and Examinations ("OCIE") to emphasize the nonbinding nature of
SEC staff statements to their staff. He also noted that the SEC’s divisions and offices, including the Division of Investment Management (“IM”), have been reviewing and will continue to review whether prior SEC staff statements and documents should be modified, rescinded or supplemented in light of market or other developments. Finally, he asserted, “it is the Commission and only the Commission that adopts rules and regulations that have the force and effect of law.”

D. SEC Withdraws No-Action Letters Related to Proxy Advisory Firms

Shortly after Chairman Clayton’s public statement described above, IM announced the withdrawal of two no-action letters it had issued in 2004 related to advisers’ reliance on the voting recommendations of proxy advisory companies. IM stated that it was withdrawing the no-action positions in light of a pending SEC Roundtable on the Proxy Process, scheduled for November 2018, and other, unstated policy considerations. The withdrawn no-action letters had provided guidance regarding the circumstances in which an investment adviser could determine that a third-party proxy advisory firm was independent for purposes of the SEC’s proxy voting rules applicable to investment advisers and, therefore, could rely on the services of the proxy advisory firm. Many investment advisers’ proxy voting policies rely on third-party proxy advisory firms to meet their duties to vote proxies in the best interests of their clients and to avoid conflicts of interest. Many mutual funds also delegate proxy voting to, and approve the proxy voting policies of, their investment advisers. Thus, the withdrawals could potentially have a large impact on investment advisers and the funds managed by them.

In a public statement published the day after the withdrawal, Commissioner Robert Jackson appeared to express concern regarding the withdrawals and that the SEC’s “efforts to fix corporate democracy will be stymied by misguided and controversial efforts to regulate proxy advisors.” Further, he stated that “it’s hard to imagine that, upon a survey of all the problems that plague corporate America today, the Commission could conclude that investors receiving too much advice about how to vote their shares—advice they are free to, and often do, disregard—should be at the top of our list.” Commissioner Jackson’s statement can be read to suggest that the withdrawal of the no-action letters was a political move, aimed at the proxy voting services, which many in the business world regard as too liberal in the positions they take.
E. **OCIE Issues Risk Alert Regarding Most Frequent Best Execution Compliance Issues**

On July 11, 2018, OCIE issued a risk alert ("Risk Alert") that provides an overview of the most common deficiencies identified in its examination of investment advisers relating to their best execution obligations under the Investment Advisers Act of 1940 ("Advisers Act"). The Advisers Act imposes a fiduciary standard upon advisers that requires them to seek "best execution" of client transactions when selecting broker-dealers and executing trades. The most frequent deficiencies identified by OCIE staff included:

- Failing to periodically and systematically evaluate the execution performance of the broker-dealers used to execute client transactions;
- Not considering materially relevant factors in reviewing a broker-dealer’s services, such as execution capability, financial responsibility and responsiveness or input from the adviser’s traders and portfolio managers;
- Utilizing certain broker-dealers without seeking comparisons or considering the quality and costs of others;
- Failing to fully disclose the adviser’s best execution practices, such as that certain types of client accounts may trade the same securities after other client accounts and the impact of that on execution prices, or that the adviser did not review trades to confirm that execution prices fell within an acceptable range;
- Failing to fully disclose the adviser’s receipt and use of soft dollar arrangements, including allocation of costs;
- Failing to administer mixed use allocations properly, such as not making a reasonable allocation of the cost of a mixed use product or service according to its use;
- Utilizing inadequate compliance policies and procedures or internal controls regarding best execution; and
- Failing to follow established best execution policies and procedures.

The Risk Alert also encouraged advisers to review and evaluate their practices, policies and procedures with respect to best execution compliance.

F. **SEC Proposes Amendments to Whistleblower Program**

On June 28, 2018, the SEC proposed amendments to the rules governing its whistleblower program. The program, established in 2010, authorizes the SEC to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful enforcement actions resulting in monetary sanctions of over $1 million. The proposed amendments would expand the type
of awards that may be issued under prosecution agreements and non-prosecution agreements, allow the SEC discretion to adjust award percentages, prevent potential double recoveries, prohibit individuals who have previously submitted false information to the SEC from submitting whistleblower applications, streamline the claims review process, and establish a uniform definition of “whistleblower” that would apply to all aspects of the program’s requirements and protections. The proposing release also includes a general inquiry for public comment regarding whether the SEC should establish a discretionary award mechanism for enforcement actions that do not meet the $1 million threshold requirement. The SEC comment period closed on September 18, 2018.

G. SEC Proposes New ETF Rule

On June 28, 2018, the SEC proposed a new rule that would permit the creation and launch of exchange-traded funds (“ETFs”) that meet certain requirements without first obtaining an SEC exemptive order. Currently, fund sponsors must file an exemptive application with the SEC requesting relief from certain provisions of the 1940 Act to operate an ETF. Although the proposed rule would permit the operation of most types of ETFs on the market today, it does not encompass all of them and those ETFs not encompassed in the proposed rule would be permitted to continue to rely on their existing ETF exemptive orders to operate. If the proposed rule is adopted, ETFs covered by the rule would no longer be permitted to rely on their exemptive orders and would instead need to comply with the requirements of the new rule. In conjunction with this proposed rule, the SEC also proposed amendments to Form N-1A that would require ETFs to make certain additional disclosures in their prospectuses and shareholder reports. The proposed rules and amendments were published in the Federal Register on July 31, 2018. Comments were due to the SEC by October 1, 2018.

H. SEC Adopts New E-Delivery Option for Shareholder Reports, Seeks Comments on Enhanced Disclosure and Disclosure Distribution Processing Fees

On June 5, 2018, the SEC took a number of actions intended to improve the delivery and content of shareholder communications.

1. New Rule 30e-3 Shareholder Report “Notice and Access” E-Delivery Option

The SEC adopted new Rule 30e-3 under the 1940 Act to permit funds to transmit shareholder reports utilizing a “notice and access” process. Under the new rule, a fund could post the report on its public website and send
shareholders a paper notice by mail that a report is available. In addition to this new option, a fund may continue to mail its reports in paper or deliver reports electronically, or some combination thereof, to investors who have chosen this method under the SEC’s e-delivery guidance. A shareholder could at any time opt to receive all future reports in paper, or request particular reports on a case-by-case basis. The notice provided to investors under the new rule must explain how to access the report and request paper copies.

To avail itself of new Rule 30e-3, a fund must:

- Make the current and most recent prior reports available on the fund’s website;
- Post quarterly portfolio holdings reports for the last fiscal year on the website;
- Include in the notice instructions on how to request a paper copy of the report or elect to receive paper reports in the future;
- Send a paper copy of the report to the investor upon request; and
- Apply the shareholder’s election to receive paper copies of reports to other funds in the same account with the fund complex or financial intermediary.

The earliest that a fund may transmit notices instead of paper reports is January 1, 2021. A fund must provide two years notice to shareholders before relying on the rule, if relying on the rule before January 1, 2022.

2. Request for Comment on Enhancing Fund Disclosure

The SEC requested feedback from individual investors, academics, literacy and design experts, market observers, and fund advisers and boards on the design, delivery, and content of shareholder reports, offering documents, advertising, and other disclosure. The SEC also asked for input on preferences for delivery methods and use of modern technology to make disclosure more interactive and personalized. Comments were due to the SEC by October 31, 2018.

3. Request for Comment on Fund Material Processing Fees

The SEC seeks comment and data on the current framework for processing fees charged by intermediaries for the distribution of disclosure materials other than proxy materials (e.g., shareholder reports and
prospectuses). Topics covered in the request include: fee assessment, fee transparency, payments received by financial intermediaries for fund document delivery, whether another entity should establish the structure and level of such fees, and the appropriateness of such fees in light of shareholder servicing fees paid from fund assets. Comments were due to the SEC by October 31, 2018.

I. President Signs Dodd-Frank Overhaul Bill

On May 24, 2018, President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Dodd-Frank Amendments”), which significantly rolls back certain bank regulations put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The act gives relief to small and mid-sized banks from certain Dodd-Frank provisions. Specifically, the act raises from $50 billion to $250 billion the asset threshold at which banks are subject to stricter Federal Reserve oversight.

The Dodd-Frank Amendments also affect investment company regulation. The new law amends Section 3(c)(1) of the 1940 Act to increase from 100 to 250 the number of investors below which a “qualifying venture capital fund” (namely, a venture capital fund that has no more than $10 million in aggregate capital contributions and uncalled committed capital) would be excluded from the definition of “investment company.” In addition, the new law also directs the SEC to adopt rules generally treating closed-end funds like other public company issuers under certain offering and proxy rules, thereby reducing filing requirements and restrictions on communications with investors in certain circumstances. The new law also amends the 1940 Act to apply the 1940 Act to investment companies created under the laws of Puerto Rico, the U.S. Virgin Islands, or any other U.S. possession.

J. SEC Proposes FAIR Act Rules to Promote Research Reports on Investment Funds

On October 6, 2017, President Trump signed into law the Fair Access to Investment Research Act of 2017 (“FAIR Act”). The act requires the SEC to establish and implement a safe harbor for certain broker-dealer investment fund research reports so that they are not deemed “offers” under securities laws.

On May 23, 2018, the SEC proposed rules and amendments aimed at promoting research on mutual funds, exchange-traded funds, business development companies, and similar covered investment funds. The rules aim to facilitate research on investment funds by harmonizing such research with research on other public entities. According to Chairman Jay Clayton, the
proposed changes “are intended to provide investors with greater access to research to aid them in making investment decisions.”

K. **SEC Proposes Relaxing Auditor Independence Requirements**

On May 2, 2018, the SEC proposed amendments to its auditor independence rules to, among other matters, relax the “loan rule,” which provides that an accounting firm is not independent from an audit client if it (or its covered persons or covered persons’ immediate family members) has received a loan from an entity or an affiliate thereof that is a record or beneficial owner of more than 10% of the audit client’s equity securities. The proposed amendments would, among other matters: (1) change the loan rule to apply only to beneficial ownership rather than to both record and beneficial ownership; (2) replace the existing 10% bright-line shareholder ownership threshold with a “significant influence” test, defined as “the ability to exert significant influence over the audit client’s operating and financial policies;” (3) add a “known through reasonable inquiry” standard for identifying beneficial owners of the audit client’s equity securities; and (4) exclude from the definition of “audit client” funds that otherwise would be considered “affiliates of the audit client.” The SEC accepted comments to the proposed rule amendments through July 9, 2018.

L. **Department of Labor Issues Statement on ESG Investing**

On April 23, 2018, the Department of Labor ("DOL") issued a bulletin providing guidance on environmental, social, and governance ("ESG") investments by ERISA fiduciaries. The guidance states that fiduciaries of ERISA-covered plans should not initiate or actively sponsor proxy fights on environmental or social issues. The guidance also explains that fiduciaries “may not sacrifice returns or assume greater risks” in order to promote ESG policy goals. However, to the extent that ESG factors involve risks that are properly treated as economic considerations in evaluating alternative investments, fiduciaries should give appropriate weight to those factors relative to the level of risk and return involved, compared to other relevant economic factors.

However, the guidance also partially approved a limited role for ESGs in 401k-type plans and in investment menus. If an investment platform allows participants and beneficiaries the ability to choose from a range of investment alternatives, and if the participants request an investment alternative that reflects their personal values, advisers may add a “prudently selected, well managed, and properly diversified ESG-themed investment alternative.” The bulletin notes that “one or two" ESG investment alternatives do not necessarily result in the plan rejecting non-ESG options. Thus the bulletin offers beneficiaries the ability to choose prudent ESG alternatives in certain cases, while reinforcing
the DOL’s “longstanding position” prohibiting ERISA fiduciaries from sacrificing performance for ESG goals.

This guidance clarifies the DOL’s previous guidance on ESG investing. In 2015, the DOL had released a bulletin stating that plan fiduciaries may not sacrifice investment return or incur additional risk in order to promote collateral social policy goals. However, that bulletin had also stated that a fiduciary’s determination of an appropriate investment must be based solely on economic considerations, but also included “those that may derive from” ESG factors. The 2015 bulletin left unclear the extent to which fiduciaries could consider ESG factors; the 2018 bulletin seeks to clarify this stance.

M. Regulation Best Interest

On April 18, 2018, the SEC voted 4-1 to open for public comment a series of proposals which aim to require brokers to act in the best interest of their customers. One obligation, named “Regulation Best Interest” would require the following measures:

- a broker-dealer discloses to its client, in writing, all of the material facts regarding the scope and terms of the relationship, including all material conflicts of interest faced by the broker-dealer in providing investment recommendations;
- the broker-dealer exercises reasonable diligence, care, skill and prudence in making its recommendations; and
- the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose, or eliminate all material conflicts of interest that are associated with its recommendations, and that are reasonably designed to identify, disclose, and mitigate, or eliminate any material conflicts of interest arising from financial incentives associated with such recommendations.

Additionally, the SEC proposed new and amended rules that would require investment advisers and broker-dealers to provide a brief relationship disclosure summary on “Form CRS” to their retail clients regarding:

- the relationships and services offered by them;
- the fees and expenses associated with such services;
- their standards of conduct;
- certain conflicts of interest; and
- certain legal or disciplinary events faced by them or their financial professionals.
This relationship disclosure summary would be provided to a “retail investor” at the beginning of his or her relationship with the firm, and would be subject to filing and recordkeeping requirements. Mutual funds would not be “retail investors” under this requirement. The proposals also restrict broker-dealers from using the term “adviser” unless they register with the SEC as investment advisers. Chairman Jay Clayton praised the rules as a “straightforward” and “multi-pronged effort “to increase investor protection and enhance the quality of advice given, without sacrificing investors’ access to and choice of brokers.

Commissioner Kara Stein voted against the proposal and issued a dissenting statement. One of the two Commission’s Democrats, Commissioner Stein criticized the proposal for largely maintaining the status quo. In her dissenting statement, Commissioner Stein wrote that the proposals “fail to provide comprehensive reform or adequately enhance existing rules.” Specifically, Stein believed that the proposal “merely reaffirms that broker-dealers have to meet their suitability obligations, requires some policies and procedures, and mandates a few disclosures.” She noted that the Commission could have improved the proposal by requiring brokers to “actually eliminate” conflicts of interest and provide “full and fair disclosures,” instead of merely requiring brokers to develop reasonable policies and disclosures. Stein also argued that the rule’s lack of a definition for “best interest” may confuse both investors and broker-dealers, complicating the industry’s efforts to institute a clear compliance path.

Commissioner Robert Jackson, the second Democrat on the Commission, “reluctantly” voted to open the proposals to public comment. However, Jackson noted that he would not have voted for the proposals in a final vote because they contain ambiguous language that could easily be used to defend brokers who engage in conflicted conduct. The proposal remained open for public comment until August 7, 2018.

N. Fiduciary Rule Developments

1. Litigation Developments Affecting the DOL Rule

On March 15, 2018, the Fifth Circuit Court of Appeals vacated the fiduciary rule, holding in a 2-1 decision that the DOL exceeded its regulatory authority in passing the rule. The decision struck down the new fiduciary advice definition and denied the attorneys-general of California, New York, and Oregon, as well as the interest group AARP the opportunity to intervene in the lawsuit.

On March 19, 2018, Massachusetts Commonwealth Secretary William Galvin condemned the decision, urging the DOL to appeal the ruling in order
“to provide certainty to customers and their advisers.” Galvin also indicated that his office will continue its ongoing case against Scottrade over alleged fiduciary rule violations stemming from sales contests.

On February 15, 2018, the Massachusetts Securities Division filed a complaint against Scottrade (now a unit of TD Ameritrade Holding Corp.), alleging that the firm failed to act in good faith to comply with the fiduciary rule, and that it violated its own internal impartial conduct rules (which it had implemented in anticipation of the DOL Fiduciary Rule) by conducting a series of “call nights and sales contests” between December 2015 and April 2017. Commonwealth Secretary William Galvin stated that these sales contests, which involved retirement assets, were designed to “drum up additional business” before Scottrade’s merger, and that these actions constituted “dishonest and unethical activity and failure to supervise.”

The complaint is one of the first actions by a state regarding fiduciary rule compliance. The complaint seeks a cease and desist order, censure, and an administrative fine against Scottrade.

2. Legislative Developments Potentially Affecting the DOL Rule

Several state legislatures have passed or introduced bills requiring advisers to be subject to a fiduciary standard notwithstanding any action taken regarding the DOL’s Fiduciary Rule. The Governor of Nevada recently signed a bill requiring broker-dealers, sales representatives and investment advisers to be subject to a fiduciary standard, and the Governor of Connecticut signed a bill to expand its fiduciary duty requirements. Legislatures in New York, New Jersey and Massachusetts have introduced similar bills, and the California State Senate introduced a resolution to the effect that, if the Fiduciary Rule is repealed, the legislature will pursue its own fiduciary standard. On February 22, 2018, Maryland proposed a statewide fiduciary rule. The state senate bill extends the fiduciary duty to brokers in order to “better align the duties of all financial advisors.”

3. Treasury Developments

On October 26, 2017, Treasury issued a report making certain recommendations with respect to the laws and regulations that apply to the asset management industry. Among other recommendations, Treasury stated that it supports the DOL effort to reexamine the implications of the Fiduciary Rule and the proposed delay in the full implementation of the Fiduciary Rule. Treasury further recommended that the SEC and DOL work together to develop uniform standards of conduct for financial professionals who provide investment advice to both retirement accounts and non-retirement account investors.
O. **New York Attorney General Releases Report Addressing Mutual Fund Fees and Disclosures**

On April 5, 2018, the New York Attorney General’s office ("NY AG") released a report regarding an investigation into mutual fund fees and disclosures. The investigation focused on actively managed equity mutual funds and the degree to which their holdings differ from those of their benchmark indexes ("Active Share"). The NY AG reported that actively managed equity funds differ widely in their Active Share and that, while institutional investors often receive information regarding funds' Active Share, retail investors often do not. The investigation surveyed 14 firms and found that only one of those firms was already publishing Active Share information. Following the investigation, the other 13 firms agreed to make public on their websites the Active Share information for their actively managed equity funds. The NY AG then “urge[d] all mutual fund firms to follow suit for their similarly-situated mutual funds.”

P. **SEC Delays Provisions of the Liquidity Rule and Issues FAQs Regarding Compliance**

On March 14, 2018, the Commission proposed amendments to the public liquidity-related disclosure requirements for certain open-end investment management companies. As adopted, Form N-PORT would require funds to disclose what percent of their assets fall into the four liquidity buckets mandated by the Liquidity Rule. The proposed amendments, however, would replace this requirement with one that funds provide narrative discussions of the operation and effectiveness of their liquidity risk management programs in their annual reports to shareholders. Although the proposed amendments do not set forth the specific types of information to be discussed in these narratives, the SEC stated that the information “should provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk,” and provided examples of the information funds may wish to include.

The Liquidity Rule, as adopted, will require funds to classify their investments into one of four liquidity buckets and report on Form N-PORT which of their assets fall into the buckets. The proposed amendments would not do away altogether with the requirement that funds engage in liquidity bucketing. However, the Commission members continue to debate very publicly the wisdom and utility of that requirement. The proposed amendments would allow a fund to classify an investment into multiple liquidity buckets if the fund has multiple sub-advisers with different liquidity views, portions of the position have differing liquidity features that justify treating the portions separately or the fund chooses to classify the position through an evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would
reasonably anticipate trading). The proposed amendments would also add a requirement that funds report their cash holdings on Form N-PORT.

The period to submit comments to the proposed amendments ended on May 18, 2018.

On February 21, 2018, the SEC adopted revised compliance dates for certain provisions of the new Liquidity Rule under the 1940 Act. Before the SEC adopted the revisions, entities with $1 billion or more were required to comply with the Rule’s provisions by December 1, 2018, and entities with less than $1 billion were required to comply by June 1, 2019. For certain provisions of the rule, those dates are now revised: larger entities’ compliance date is now June 1, 2019, smaller entities’ compliance date is December 1, 2019.

The delayed compliance dates apply to the following four requirements of the Liquidity Rule: (1) full portfolio classification (the “bucketing requirement”); (2) highly liquid investment minimum; (3) Board oversight of a Liquidity Risk Management Program; and (4) disclosure requirements of Part D of Form N-LIQUID, the recently-adopted form for notifying the SEC of certain liquidity events, and certain disclosures on Form N-PORT, the recently-adopted form for monthly reporting of portfolio holdings.

Not all provisions of the Rule are delayed. Specifically, the provisions related to (1) the adviser’s assessment, management, and periodic review of liquidity risk; (2) the 15% restriction on illiquid investments; (3) the establishment of procedures for funds that engage in, or reserve the right to engage in, redemptions in-kind; (4) Form N-LIQUID reporting related to general liquidity information and reporting related to illiquid investments; and (5) Form N-CEN reporting (which requires annual reporting of census-like information) related to lines of credit, inter-fund lending and borrowing as well as In-Kind Exchange-Traded Fund status reporting are not delayed.

The SEC stated that it was delaying the compliance date of certain provisions of the Rule because it had underestimated the extent to which fund complexes would rely on third-party vendors to classify and monitor the liquidity of portfolio securities. The SEC also stated that the third-party vendors required additional time to be able to assess a broader range of securities.

Also on February 21, 2018, the IM staff issued guidance in the form of FAQs related to fund compliance with provisions of the Liquidity Rule. This guidance generally relates to classification of portfolio securities, stating that a fund could classify and review portfolio investments according to their asset class if the fund had a process to consider security-specific information that might cause a security’s liquidity classification to deviate from its asset class. A fund could rely
on automated processes to consider that security-specific information, but the
staff would expect periodic review of the automated processes.

The staff also stated that a fund could make an asset class determination
of what would constitute a reasonable trade size, for the purposes of analyzing
market depth and estimating liquidity. In this regard, even if a fund anticipated
liquidating its entire position in a security, the fund could continue to estimate
liquidity by utilizing the trade size appropriate to the asset class, rather than what
the fund actually anticipated selling. Additionally, if a fund held shares of
another investment company, the staff would not expect the fund to “look
through” the portfolio of that investment company (unless the fund has a reason
to believe that those underlying investments could cause a material change in
its view of the shares' liquidity.)

The staff stated that it would expect funds to analyze their holdings daily
for the purposes of ensuring the fund does not reach the 15% limit on illiquid
investments. However, a fund would not need to classify securities in its portfolio
more that once a month (absent certain indicia).

The FAQ guidance issued February 21, 2018 came less than two months
after the staff first issued guidance on the Liquidity Rule. On January 10, 2018,
the SEC Staff issued a set of FAQs that focused on sub-advised funds and ETFs.

Among other matters, the January FAQs (1) confirm that a sub-adviser
may be designated by a fund board to serve as the fund’s liquidity risk
management program administrator, (2) state that the liquidity risk
management program administrator may delegate specific duties to a sub-
adviser, provided that the administrator performs appropriate oversight, (3) note
that, although the Liquidity Rule requires funds, rather than advisers, to adopt
and implement liquidity risk management programs, the SEC staff contemplates
that advisers will assume various duties under the programs, and (4) recognize
that an adviser may provide advisory services to multiple funds and
acknowledge that, in such instances, the adviser is not required to reconcile
differences among multiple liquidity risk management programs.

The January FAQs also state that different funds may classify the liquidity
of similar investments differently, which could result in differing classifications of
the same investment from fund to fund. If classification duties for a fund are
delegated to both the adviser and one or more sub-advisers and they reach a
different conclusion regarding the appropriate liquidity categorization, the FAQs
provide that the administrator is not required to resolve such differences, though
the fund could choose to adopt policies and procedures that establish a
methodology to resolve them. A fund must, however, reconcile any
classification differences for purposes of Form N-PORT reports, and the FAQs provide examples of how these differences can be resolved.

Q. **SEC Releases Guidance on Cybersecurity**

On February 21, 2018, the SEC approved new guidance detailing how public companies should report cybersecurity risks and incidents. In 2011, the Commission’s Division of Corporation Finance had issued interpretive guidance in this area. The recent guidance added two additional subjects to the 2011 guidance: (1) the importance of developing procedures to determine when cybersecurity incidents are material and require disclosure, and (2) the applicability of insider trading rules in cybersecurity incidents. The guidance stresses the importance of developing comprehensive procedures allowing companies to accurately and timely disclose material cybersecurity events. According to the guidance, companies should consider cybersecurity risks and incidents when preparing its disclosures required under the Securities Act of 1933 and the Securities Exchange Act of 1934. These risk factors include (1) the occurrence and severity of prior cybersecurity incidents, and (2) the probability and potential magnitude of future occurrences.

Significantly, the full Commission released the recent guidelines, so they may carry more heft than the Division of Corporation Finance’s 2011 guidance. However, the recent release expressly does not address cybersecurity risks that are specific to investment companies, or other regulated entities under the federal securities laws, including investment advisers, brokers, and dealers. Nevertheless, the guidance is an important expression of the Commission’s thinking on cybersecurity.

Notably, the two Democratic commissioners criticized the new guidance as insufficient. Commissioner Kara M. Stein publicly stated that the recent guidelines largely reiterated the staff’s 2011 guidance. Commissioner Stein noted that the new guidelines could have discussed new technological developments against cyberattacks since 2011, examples of effective company cyber-related disclosures, and practitioner’s comments. Commissioner Robert Jackson expressed his “reluctant support” for the guidance, stating that it represents only a “first step” and that “much more needs to be done” on the issue.

R. **SEC Delays Filing Compliance Date for Reporting Modernization Rule**

On December 8, 2017, the SEC issued a temporary rule postponing the compliance date for funds to make filings required by Form N-PORT. The SEC noted that the postponement was the result of industry concerns regarding the cyber security of the SEC’s EDGAR filing system. The postponement means that investment companies with assets of $1 billion or more must now file on Form N-
PORT by April 30, 2019. Those investment companies will still be required to maintain Form N-PORT information internally as of the original compliance date of June 1, 2018 and make it available to the SEC upon request. The temporary rule also extends the period during which funds must file on the current Form N-Q, which will be replaced by Form N-PORT.

S. SEC Division of Enforcement Announces Enforcement Results and Priorities

On November 15, 2017, the SEC’s Division of Enforcement announced its enforcement results for fiscal year 2017 and its enforcement priorities for fiscal year 2018. The announcement indicated that the SEC brought 754 enforcement actions during FY 2017, resulting in more than $3.7 billion of fines and disgorgement. Approximately 80 of the enforcement actions targeted investment advisers or investment companies. The Division of Enforcement also outlined the five principles that will guide its enforcement efforts in FY 2018, which are to:

- Protect “Main Street” investors, including by pursuing accounting fraud, sales of unsuitable products, unsuitable trading strategies, pump and dump frauds, and Ponzi schemes. The Division of Enforcement established a Retail Strategy Task Force to develop strategies to target behavior that harms retail investors.
- Focus on individual accountability, which the Division of Enforcement believes will more effectively deter wrongdoing.
- Keep pace with technological innovations. In this regard, the Division of Enforcement created a Cyber Unit to focus on cyber intrusions, distributed ledger technology, and the “dark web.”
- Consider the range of sanctions available in each case, rather than pursuing a formulaic or statistics-oriented approach.
- Constantly assess the allocation of the Division of Enforcement’s resources.

T. SEC Officials Discuss Enforcement and Rulemaking Developments

On October 26, 2017, SEC Commissioner Michael Piwowar delivered a speech at the Financial Industry Regulatory Authority and Columbia University Market Structure Conference, stating that the SEC’s past “broken windows” approach to enforcement was misguided, and the SEC should chart a new course. Commissioner Piwowar also stated that the SEC would move away from the Dodd-Frank rulemaking initiatives undertaken in prior years. On the same day, Steven Peikin, the Co-Director of the SEC’s Division of Enforcement, delivered a speech indicating that the SEC intends to conduct fewer sweep examinations, bring fewer enforcement actions for “minor” infractions, and
decrease its enforcement staff. Finally, Mr. Peikin stated that the SEC may depart from the admissions policy of former SEC Chair White, pursuant to which the SEC sought admissions of wrongdoing by firms and individuals in certain instances.

On November 8, 2017, SEC Chairman Jay Clayton announced that he intends to shorten the SEC’s rulemaking agenda. With a reduced agenda, Mr. Clayton expects that the SEC will be more readily equipped to react to major world events, such as the European Union’s Markets in Financial Instruments Directive ("MiFID II"). Mr. Clayton also stated that the SEC will shift its focus to deterring and mitigating wrongdoing before enforcement actions become necessary. In addition, Mr. Clayton indicated that the SEC is reviewing mutual funds’ fee disclosures to determine whether any change to the related disclosure requirements may be appropriate.

U. **Treasury Department Recommends Regulatory Reforms to Implement President Trump’s “Core Principles”**

On October 26, 2017, the U.S. Department of the Treasury issued a report regarding the regulatory framework applicable to the asset management and insurance industries and providing recommendations thereto. Among other matters, Treasury made the following recommendations:

- **Financial Stability Oversight Council.** Treasury recommended that FSOC and federal regulators stop evaluating asset managers or funds at the entity level and instead focus on potential systemic risks arising from specific products and activities. Treasury also recommended repealing the existing Dodd-Frank Wall Street Reform and Consumer Protection Act requirement that the SEC promulgate regulations requiring registered funds and advisers with more than $10 billion in consolidated assets to conduct annual stress tests. The SEC has not yet proposed rules in response to this requirement.

- **Liquidity Risk Management Programs.** Treasury criticized the rule adopted by the SEC in 2016 that will require mutual funds to adopt liquidity risk management programs meeting certain prescribed standards, noting that it “mandates an overly prescriptive asset classification or bucketing methodology.” Treasury recommended that the SEC instead adopt a “principles-based approach” to liquidity risk management programs. The Treasury did, however, support the rule’s 15% limit on a mutual fund’s investments in illiquid assets.

- **Derivatives.** Treasury urged the SEC to reconsider its proposed rule that would regulate funds’ use of derivatives, adjust the portfolio leverage limits in the proposed rule and reconsider the
types of assets that could qualify as segregated assets. It also recommended that the Commodity Futures Trading Commission amend its rules to exempt investment companies registered with the SEC and their advisers from dual registration and regulation as commodity pool operators, and that the CFTC and SEC identify a single regulator for investment companies acting as “de facto” commodity pools.

- **Exchange-Traded Funds.** Treasury recommended that the SEC adopt a rule permitting the operation of “plain vanilla” ETFs without requiring them to obtain separate SEC exemptive relief.
- **Business Continuity Plans.** Treasury recommended that the SEC withdraw its proposed rule that would require investment advisers to adopt written business continuity and transition plans meeting certain prescribed standards.
- **Shareholder Communications.** Treasury recommended that the SEC finalize its proposed rule to permit funds to provide shareholder documents and other appropriate disclosure electronically in the absence of further instruction from shareholders.
- **Variable Annuities.** Treasury recommended that the SEC adopt rules permitting variable annuities to use summary prospectuses, streamlining the annual prospectus update provided to existing contractholders, and allowing online access to annual updates and underlying fund literature. Treasury also noted that it would work with the U.S. Department of Labor to develop proposals encouraging the inclusion of annuities as investment options in employer-sponsored retirement plans.
- **Fiduciary Rule.** Treasury also made recommendations regarding the DOL “Fiduciary Rule,” which is discussed in greater detail above.

V. **Treasury Department Recommends Changes to SIFI Designation Process**

On November 17, 2017, Treasury released a memorandum to President Trump recommending changes to FSOC’s systemically important financial institutions designation process. The recommendations included mandating cost-benefit analysis when evaluating institutions for potential SIFI designation, combining the three stages of review into two stages to clarify the process and make it more consistent with the financial market utilities framework, and changing the initial $50 billion asset threshold for initiating a SIFI review to “more appropriately tailor it to the risk that an institution could pose to financial
stability.” The Investment Company Institute welcomed the recommendations as a step in the right direction.

W. **IDC Sends Letter to IM Director Requesting Modernization of Fund Board Responsibilities**

On October 16, 2017, the Independent Directors Council sent a letter to Dalia Blass, the Director of IM, requesting that IM prioritize modernizing and clarifying fund directors’ responsibilities. Noting that the SEC “has continuously added new responsibilities for fund boards, without eliminating or paring down existing ones,” the IDC Letter requests that IM pursue a holistic review of the number of regulatory requirements for fund boards and the nature of these requirements, which the IDC Letter notes have in some cases expanded boards’ responsibilities beyond oversight and into management functions.

The IDC Letter proposes a framework for the SEC to evaluate the responsibilities appropriate for fund boards under the 1940 Act, noting that fund boards are subject to state law fiduciary duties of care and loyalty and that the 1940 Act adds responsibilities primarily to address conflicts of interest. The IDC Letter notes that the interests of the adviser and shareholders are aligned in many cases, and therefore the SEC should “focus board responsibilities on those matters where there is a clear conflict of interest—not simply a theoretical one—and on tasks where directors can add tangible value.” In this connection, the IDC Letter recommends that the SEC not impose responsibilities on fund boards that duplicate fund compliance programs or require boards to have subject matter expertise.

The IDC Letter also proposes certain specific modifications. First, the IDC Letter recommends changes to directors’ responsibilities, such as: (1) adopting a rule to permit boards to oversee the fair valuation process to address conflicts of interest but allowing them to delegate fair value determinations to the adviser; and (2) no longer requiring boards to evaluate Rule 12b-1 payments quarterly or requiring that they consider certain “irrelevant” factors that are listed in the adopting release. Second, the IDC Letter recommends eliminating “routine and ritualistic” board responsibilities that should be addressed by the adviser or the chief compliance officer, such as requirements that boards: (1) determine that a seller’s obligation in a repurchase agreement is “collateralized fully,” as defined by the 1940 Act; (2) determine quarterly that all affiliated transactions complied with board procedures required by exemptive rules; (3) examine reports detailing the routine placement of foreign assets; (4) determine the form and amount of a fidelity bond; (5) determine, pursuant to Rule 18f-3, that the rates of return among share classes will differ only because of differences in expenses; and (6) set the time for computing net asset value. Finally, the IDC Letter recommends that the SEC revise governance requirements, such as by: (1) allowing funds to waive the requirement that certain board actions, such as
approving advisory and underwriting contracts, approving a Rule 12b-1 plan, and selecting a fund’s independent public accountant, must occur at an in-person meeting, if the board determines that such a waiver is appropriate; and (2) permitting board members to be considered independent when they hold de minimis interests in a fund’s unaffiliated sub-advisers and their parent companies.

The Mutual Fund Directors Forum previously submitted a letter to SEC Chairman Clayton on June 20, 2017 requesting that the SEC conduct a wholesale review of director responsibilities. The letter suggests that the SEC reconsider the role played by directors under “the current regulatory regime, the tasks imposed on directors by that regime, and whether the specific tasks given to directors in fact succeed in enabling directors to better protect the interests of shareholders.” It further notes that “[w]e are concerned that the Commission’s approach in recent years has placed too many burdens on directors, has gone too far in implicitly impelling them to become involved operationally in their funds [sic] activities, and thus has inhibited their ability to spend time on issues that matter most to their shareholders and to exercise their business judgment flexibly on behalf of those shareholders.”

X. MiFID II Developments

1. MiFID II

In 2014, the European Parliament and European Council adopted an updated version of the European Union’s Markets in Financial Instruments Directive, including a revised Directive and a Markets in Financial Instruments Regulation (collectively, “MiFID II”). MiFID II will impose new obligations on many global investment managers that, to date, have avoided substantive regulation in the EU. The areas of reform include: (1) internal organization and governance; (2) market structure; (3) market transparency; (4) investor protection; and (5) reporting and market oversight. The implementation date for MiFID II is January 3, 2018.

2. Application to U.S. Investment Managers

MiFID II applies primarily to investment managers in the EU; however, it will impact U.S. and other non-EU investment managers as well. Determining which MiFID II provisions apply will depend on a manager’s particular circumstances and its contacts with the EU. In addition, MiFID II firms that engage investment managers operating outside of the EU to provide sub-advisory services may also seek to impose contractual obligations on those sub-advisers to comply with certain MiFID II requirements on a look-through basis. MiFID II also will change the European market structure and increase transparency obligations, which could reduce liquidity in the European fixed income market, and establish
position limits in commodity derivatives that are traded on the European markets. Further, MiFID II will impact the way in which non-EU investment managers market cross-border products and services to European clients, such as separately managed accounts and pooled investment accounts.

3. MiFID II Requirements Relating to “Soft Dollars”

For investment companies, new requirements under MiFID II relating to the payments for third-party research could be problematic. MiFID II will require that investment managers disclose, separately, the costs for trade execution and research. In addition, an investment manager subject to MiFID II may only obtain research from third parties if it pays for the research directly from its own resources, or if the research is paid from a separate research payment account (“RPA”) controlled by the manager funded by a research budget that will be set, regularly assessed, and agreed upon with each client. This differs greatly from practices in the U.S., where managers bundle trade execution and research payments together and use client dealing commissions to pay for research provided by broker-dealers.

4. Related SEC No-Action Relief

In response to the requirement regarding separation of execution and research payments, the ICI submitted a request to the SEC for no-action relief on October 20, 2017. Specifically, the ICI asked the SEC staff to expand the position it took in SMC Capital, Inc. (pub. avail. Sept. 5, 1995), with respect to the aggregation of trade orders, in order to accommodate the differing arrangements regarding the payment for research that will be required under MiFID II. The SMC Letter permits investment managers to aggregate trade orders among funds and other clients, so long as the funds participated on terms not less advantageous than other participants. In addition, the SMC Letter includes a representation that transaction costs be shared by clients pro rata based on each client’s participation in the transaction. However, after MiFID II goes into effect, varying research arrangements among clients could result in some clients not paying a pro rata share of the research costs associated with the aggregated order, although all clients would continue to pay the same average security price and execution rate. The SEC granted the requested relief based, in part, on the ICI’s representation that the manager would adopt policies and procedures reasonably designed to ensure that:

1. each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate);
2. the payment for research in connection with the aggregated order will be consistent with each applicable jurisdiction’s regulatory requirements and disclosures to the client; and
(3) subsequent allocation of such trade will conform to the adviser’s allocation statement and/or the adviser’s allocation procedures.

Further, on October 26, 2017, in a letter to the Securities Industry and Financial Markets Association, the SEC stated it would not recommend enforcement action where a broker-dealer provides to an investment manager research services constituting investment advice under the Advisers Act, where the investment manager is required by MiFID II, to pay for research services from the manager’s own assets, from an RPA, or from a combination of the two. The Advisers Act excludes from the definition of investment adviser, any broker or dealer who performs investment advisory services, the performance of which is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor. SIFMA’s concern was that the payment for research services could be deemed special compensation thereby subjecting the broker-dealer’s research services to the Advisers Act. The SEC’s assurance is temporary, however, and will expire thirty months after MiFID II’s implementation date.

On the same date, in a letter to the SIFMA Asset Management Group, the SEC staff stated that it would not recommend enforcement action against a manager that pays for research through an RPA in reliance on Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) provides a safe harbor that allows managers to use client funds to purchase brokerage and research services for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. In a 2006 interpretive release, the SEC confirmed that client account arrangements, a method used by managers to pay for Section 28(e) eligible research using client transaction commissions, qualify under Section 28(e). Noting the similarities between client account arrangements and RPAs, the SIFMA Asset Management Group urged the staff to make clear that RPAs would also qualify under Section 28(e). The SEC staff granted the requested relief in the following circumstances:

- The manager makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution.
- The research payments are for research services that are eligible for the safe harbor under Section 28(e).
- The executing broker-dealer effects the securities transaction for purposes of Section 28(e).
- The executing broker-dealer is legally obligated by contract with the manager to pay for research through the use of a research payment account in connection with a client commission arrangement.
III. Recent Court Proceedings

A. Section 36(b) Excessive Fee Lawsuit Developments

1. Pacific Investment Management Company LLC and PIMCO Investments LLC

On September 10, 2018, the U.S. District Court for the Western District of Washington ordered that the parties' cross-motions for summary judgment and all briefings, declarations, exhibits, and materials offered in support thereof in the related Section 36(b) lawsuit against Pacific Investment Management Company LLC and PIMCO Investments LLC (collectively, “PIMCO”), shall remain sealed and shall not be unsealed unless by further order of the court. This case was notable because in 2016, it became the first in the mutual fund context in which a court recognized a “fiduciary exception” to the attorney-client privilege in requiring the defendants to produce communications between the independent trustees of the related PIMCO fund and their counsel.

On August 8, 2018, PIMCO and the plaintiff in this case filed a stipulation of dismissal with prejudice to prevent the plaintiff from bringing another lawsuit against PIMCO based on the same facts.* According to industry reports, PIMCO and the plaintiff filed the stipulation of dismissal pursuant to a settlement agreement, which PIMCO hoped would prevent certain documents produced by it during the proceedings from becoming public. On August 9, 2018, however, the court stated that the stipulation of dismissal may not, by itself, be sufficient to prevent the public disclosure of the PIMCO documentation and indicated that PIMCO would need to justify why the documents should be expunged from the record. In the September 10 order sealing the records, the court stated that it “does not condone negotiating to seal documents the Court has already ruled to unseal. Nevertheless, the Court reluctantly agrees that the public's interest in the documents has significantly decreased with the Court no longer ruling on the corresponding Motions for Summary Judgment.”

2. Hartford Funds Management Company, LLP and Hartford Investment Financial Services

On August 15, 2018, the U.S. Court of Appeals for the Third Circuit (“Third Circuit”) affirmed the U.S. District Court for the District of New Jersey’s decision in favor of Hartford Funds Management Company, LLP and Hartford Investment Financial Services (together, “Hartford”) in a Section 36(b) lawsuit brought

* The plaintiff filed a complaint in December 2014 alleging that PIMCO breached its fiduciary duty to the PIMCO Total Return Fund ("PIMCO Fund") by charging the PIMCO Fund excessive advisory, administrative, and distribution and servicing (Rule 12b-1) fees and failing to pass on economies of scale to the PIMCO Fund.
against Hartford. The plaintiffs had claimed that Hartford charged excessive fees for six subadvised mutual funds, retaining the majority of the advisory fees while the funds’ subadvisors did most of the work. After granting Hartford’s motion for summary judgment in part with respect to the independence and conscientiousness of the board of directors in evaluating the advisory fees, the District Court held a trial to address the remaining Gartenberg factors, concluded that none of those factors favored the plaintiffs and ruled in favor of Hartford. In a non-precedential decision that is non-binding on lower courts, the Third Circuit reviewed the District Court’s analysis of the Gartenberg factors, and held the District Court properly found that the plaintiffs failed to meet their burden to demonstrate that “the fees charged by the funds’ investment advisors were excessive in relation to the services they provided.”

Although the Third Circuit’s decision is non-precedential, it seems significant that they specifically rejected the plaintiffs’ argument that the court should “artificially bifurcate” the management contract into the portion retained by Hartford and the portion paid to its sub-administrator, and look separately at the fees and profitability under each portion. “Nothing in the statute, nor in our precedent, requires such a distinction. Nor does the statute prohibit an investment manager from subcontracting some of its management responsibilities.” While the decision is non-precedential, it almost goes without saying that lower courts do not like to have their decision reversed by appellate courts. Thus, lower courts may look to a statement like this in determining how they will deal with these cases.

3. AXA Equitable Life Insurance Co.

On July 10, 2018, the Third Circuit affirmed the ruling of the U.S. District Court for the District of New Jersey (“District Court”) that had ruled in favor of AXA Equitable Life Insurance Company and AXA Equitable Funds Management Group, LLC (together, “AXA”) in August 2016 in a Section 36(b) lawsuit brought against them following a 25-day trial on the merits. This was the first excessive fee case to go to trial since 2009. Plaintiffs had alleged that AXA charged several mutual funds to which it serves as the investment adviser excessive management and administrative fees while delegating most of its duties to sub-advisers and sub-administrators. The District Court’s 159-page decision was fact-driven and concluded that the plaintiffs did not meet the standard set by the Court in Jones v. Harris because the plaintiffs failed to demonstrate that AXA “charge[s] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” After reviewing each of the Gartenberg factors, the District Court found that the plaintiffs failed to demonstrate that AXA breached its fiduciary duty in violation of Section 36(b). Additionally, the District Court found that the funds’ board of trustees was sufficiently independent and
diverse, that the board robustly reviewed AXA’s compensation and received “comprehensive training” and that plaintiffs failed to demonstrate how much AXA actually retained in fees. Much of the District Court’s ruling rested on its evaluation of the two sides’ witnesses. The court for the most part found the witnesses for AXA to be credible, while those for the plaintiffs often lacked credibility.

The Third Circuit noted that, on appeal from a district court, courts of appeals defer to the lower court’s findings of fact unless there is a “clear error” in the facts and limit their review to a de novo consideration of the law. In this light, the Third Circuit reviewed the District Court’s analysis of the Gartenberg factors and concluded that “the District Court wrote a thorough and comprehensive opinion that the [plaintiffs] have failed to undermine.” The Third Circuit upheld the District Court’s detailed factual findings and evaluations of the credibility of each side’s witnesses. However, the court also concluded that the decision would be non-precedential, that is non-binding on lower courts, because it did not address novel legal issues.

4. BlackRock Entities

On June 13, 2018, the U.S. District Court for the District of New Jersey granted in part and denied in part a motion for summary judgment filed by BlackRock Investment Management, LLC, BlackRock Advisors, LLC and BlackRock International Limited (collectively, “BlackRock”) in a Section 36(b) case brought against BlackRock. The plaintiffs in this case had alleged that BlackRock breached its fiduciary duty to two mutual funds by charging them excessive advisory fees based principally on allegations that BlackRock charged one of the funds more than the sub-advisory fee rates that BlackRock charged to other clients with supposedly similar investment programs, delegated a significant portion of its responsibilities for one of the funds to an affiliated subadviser while retaining most of the fees, and failed to pass on economies of scale. The District Court granted BlackRock’s motion in part by ruling that the BlackRock funds’ board of directors’ decision to approve the funds’ investment advisory fee was entitled to substantial deference, but the District Court denied the motion in part because it found that, under the Gartenberg factors, material factual disputes existed regarding BlackRock’s comparative fees, economies of scale and profitability.

5. Chamber of Commerce Amicus Brief in J.P. Morgan Section 36(b) Case

As you may recall, on March 9, 2018, the U.S. District Court for the Southern District of Ohio granted J.P. Morgan Investment Management, Inc.’s (“J.P. Morgan”) motion for summary judgment in a set of consolidated actions
brought against J.P. Morgan under Section 36(b) of the 1940 Act. On March 13, 2018, the plaintiffs filed a notice of appeal to the U.S. Court of Appeals for the Sixth Circuit ("Sixth Circuit"). On July 27, 2018, the Chamber of Commerce of the United States of America filed an amicus brief with the Sixth Circuit in support of the defendants, urging that the district court's decision be affirmed. The Chamber's brief highlighted how costly, time-consuming and wasteful Section 36(b) litigation is for defendants. It argued that Section 36(b) litigation should be narrowly focused on the issue of whether the Jones v. Harris standard has been met (i.e., whether an advisory fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining"), rather than based on an exhaustive analysis of each Gartenberg factor.

The Chamber additionally argued that "Jones does not require in-depth analysis of every factor in every case" and that the Gartenberg factors should not be treated "as if they were elements of a § 36(b) claim of defense." The Chamber noted that "[t]he Gartenberg factors, if treated with too much care, can needlessly multiply effort and expense" and "unnecessarily prolongs these cases." Instead, the Chamber believes that the Court's review should be limited to the appropriateness of the fee and the performance of the fund compared with its peers. The Chamber argued that "[a]n adviser who charges a fee that is in line with the fees charged by advisers to similar mutual funds cannot be said to fall outside the range of what could have been negotiated through arm's-length bargaining. An adviser who provides above-average performance net of its fees cannot be said to charge fees that are unreasonable in relation to its services." If both are true, the Chamber argued, the case should be dismissed for failure to meet the Jones standard in order to avoid costly, time-consuming litigation.

The Chamber's argument should be approached with care. By inviting courts to pass over the Gartenberg factors and simply determine whether an advisory fee is disproportionately large, the Chamber's approach would seem to open the door for courts to substitute their judgment for that of fund boards. Also, the Supreme Court in Jones specifically cautioned against judging mutual fund fees primarily based on comparison to those of alleged peer funds. By emphasizing fund performance in its evaluation of the adviser's services, the Chamber seems to be disregarding the many other services that fund managers provide and tossing away precedent that emphasizes the overall quality of the services, regardless of whether the fund may have suffered a period of poor performance. The Chamber's approach might insulate from Section 36(b) allegations the advisers of some large fund complexes in some situations, but it would also seem to expose other funds in ways they are not exposed under current precedent.
6. **Metropolitan West Asset Management, LLC**

On May 17, 2018, the U.S. District Court for the Central District of California denied a motion by plaintiffs in a Section 36(b) lawsuit against Metropolitan West Asset Management, LLC (“Met West”) to obtain discovery of emails between the independent trustees of Metropolitan West Funds (“Met West Funds”) and their independent trustee counsel. The plaintiffs in this case alleged that Met West breached its fiduciary duty to the $68 billion Total Return Bond Fund, to which Met West served as the investment adviser, by charging excessive advisory fees.

The plaintiffs in this case sought to demonstrate that communications between the trustees of the Met West Funds and their independent counsel were not protected by attorney-client privilege under what is known as the “fiduciary exception,” which the U.S. Court of Appeals for the Ninth Circuit has recognized in the PIMCO decision discussed above. Met West argued that the PIMCO decision “inappropriately placed the burden on the independent trustees to disprove an applicable exception to the attorney-client privilege” when this burden should have fallen on the plaintiff, and further argued that the court in the PIMCO decision “failed to analyze the rationales for applying the fiduciary exception.” The Court agreed with Met West on both arguments, and recognized the distinction between a “business trust” and a common law trust, noting that a business trust, like the fund at issue, is more analogous to a corporation in that it creates only the relationship of trustee and beneficial owner.

7. **Harbor Capital Advisors, Inc.**

On March 13, 2018, the U.S. District Court for the Northern District of Illinois granted Harbor Capital Advisors, Inc.'s (“Harbor”) motion for summary judgment in a set of consolidated actions brought against Harbor under Section 36(b) of the 1940 Act. The plaintiffs in this case alleged that Harbor breached its fiduciary duty to multiple funds by delegating substantially all of its advisory service responsibilities to sub-advisers, while retaining a substantial portion (up to 45%) of the advisory fees paid by each fund, and failed to pass economies of scale on to the funds.

In granting Harbor’s motion, the court determined that the plaintiffs had not pointed to any admissible evidence to contest the fund board’s Section 15(c) advisory contract review process or its independence, nor did the plaintiffs show that the board was uninformed or that the Section 15(c) advisory contract review process was otherwise tainted. Therefore, the court determined, the board’s decisions were “entitled to substantial weight."
The court then evaluated the factors identified in Gartenberg v. Merrill Lynch Asset Mgmt., Inc., and ultimately concluded that the plaintiffs had failed to demonstrate the existence of a genuine issue of fact requiring trial. Notably, in reviewing the nature and quality of the services provided to the funds, the court determined that combined services performed both by Harbor and its sub-advisers should be considered against the advisory fee paid by the funds to Harbor, and rejected the plaintiffs’ contention that only those services performed directly by Harbor should be considered. The court noted that “but for the agreement between the Funds and [Harbor], the performance of services provided to the Funds by the subadvisers would not have been secured.”

8. Western Asset Management Co.

On April 26, 2018, a fund shareholder sued Western Asset Management Co. ("WAMCO") in the federal district court in California under Section 36(b) of the 1940 Act. In Winston v. Western Asset Management Company et al, the plaintiff claims that WAMCO charged two of its closed-end funds excessive fees compared to an open-end fund that WAMCO manages in a similar style, and compared to certain private clients. Before filing this suit, the plaintiff shareholder had engaged in an extensive campaign to secure a reduction in the funds' fees. These efforts included privately writing to the chairman of the board and publishing an article alleging that fund management prioritized its interests over clients and hid conflicts of interest. Though the funds announced pending fee reductions, the plaintiff has alleged that these measures are mere “window dressing” and that the fees remain excessive. The plaintiff seeks to recover damages and rescission of the investment advisory agreements with the funds' investment advisers. The Defendants were due to file their answer to the complaint by July 2, 2018.

B. SEC Settles Enforcement Action Against Transamerica Entities

On August 27, 2018, the SEC settled an enforcement action against three Transamerica advisory entities and their affiliated broker-dealer (collectively, “Transamerica”)† related to the offer, sale and management of 15 mutual funds and other investment products managed pursuant to a quantitative model. The Transamerica entities agreed to settle the SEC’s charges and pay nearly $53.3 million in disgorgement, $8 million in interest, and a $36.3 million penalty. In consenting to the order, the Transamerica entities neither admitted nor denied the SEC’s findings.

† AEGON USA Investment Management, LLC, Transamerica Asset Management, Inc., Transamerica Capital, Inc. and Transamerica Financial Advisors, Inc.
Among the charges brought against the funds' advisers was that they had violated Section 15(c) of the 1940 Act, “which requires an investment adviser (and, in this case, also the sub-adviser) to a registered investment company, such as a mutual fund, ‘to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby [it] undertakes regularly to serve or act as investment adviser …’ to the fund.”

In separate orders, the SEC found that the former Global Chief Investment Officer of one of the Transamerica advisory entities did not take reasonable steps to reasonably ensure the mutual funds' models worked as intended, and that he and the former Director of New Initiatives both contributed to the adviser's compliance failings. Both individuals agreed to settle the charges without admitting or denying the findings and pay, respectively, $65,000 and $25,000 in penalties and disgorgement.

C. SEC Settles with SEI Global Fund Services on Valuation Case

On April 26, 2018, the SEC and SEI Investments Global Fund Services ("SEI") settled a valuation case for $225,000. Section 17(a) of the 1940 Act prohibits transactions in money or property between funds and their affiliated persons, though Rule 12d1-1 provides an exemption in certain cases. The SEC had brought an action alleging that SEI's management and pricing of an unregistered money market fund (the “Liquidity Fund” or “Fund”) caused the Fund to fail to satisfy the conditions necessary for SEI to rely upon an exemption under 12d1-1.

SEI had utilized the Liquidity Fund as a vehicle for reinvesting cash collateral obtained from other SEI funds' securities lending activities. Although the Liquidity Fund was not registered as an investment company under the 1940 Act, it was still subject to the restrictions of Section 17. Rule 12d1-1 provides an exemption to allow registered funds to use an affiliated money market fund for cash management, but the money market fund must meet certain conditions, even if it is unregistered. Among those conditions are compliance with Rule 2a-7, which regulates the operation of money funds, and with Section 18 of the 1940 Act, which prohibits the issuance of multiple classes of shares except pursuant to an exemptive rule or order.

According to the complaint, in July 2008, the Liquidity Fund’s shadow price dropped below $0.995. In response, SEI advised both the board of the investing funds and the SEC that it was switching from a stable $1.00 per-share NAV to a floating NAV. However, the general partnership structure of the Fund apparently created problems for the use of a floating NAV. Thus, SEI continued to book trades into and out of the Liquidity Fund at $1.00 per share, but kept a side accounting sheet on which it recorded what it believed were the real prices of the transactions, taking account of the market value of the portfolio.
securities. The SEC charged that this method was not in accordance with Rule 2a-7. Furthermore, the differences between the $1.00 NAV and the market-based NAV were not allocated to funds that were started in 2009 and later. This approach, the SEC charged, created a second class of shares in the money fund and was not in accordance with Section 18.

The SEC also alleged that the allocation methods used by SEI in keeping the side spreadsheet did not produce the same allocation as would have resulted if SEI had used the actual floating NAV to price the Liquidity Fund’s shares each day. The SEC estimated that the method used by SEI resulted in the misallocation of $13.8 million across 31 funds with aggregate net assets of $40 billion. There is no indication in the order that SEI repaid any amount to the affected funds, or that the impact on any fund was sufficient to require repricing of fund shares.

As a result of these actions, SEI “caused the Liquidity Fund to violate Sections 17(a)(1) and (17)(a)(2) of the 1940 Act” by engaging in transactions between funds and affiliated persons.

D. SEC Awards Two Whistleblowers More Than $2 Million Each

On April 5, 2018, the SEC awarded a whistleblower payment of more than $2.2 million to a former company insider whose tips allowed the SEC to open an investigation and institute an enforcement action. The whistleblower first reported the information to another federal agency, which referred the case to the SEC. The whistleblower then reported the same information directly to the SEC. This award is the first paid under Rule 21F-4(b)(7) of Securities Exchange Act of 1934. The rule provides that, if a whistleblower first submits information to another federal agency covered by the rule, and subsequently submits the same information to the SEC within 120 days, the SEC may treat that information as though it had been submitted at the earlier date.

On April 12, 2018, the SEC announced another whistleblower award of more than $2.1 million to a former company insider whose information led the multiple enforcement actions.

E. SEC Settles with Voya Investments, LLC and Directed Services LLC

On March 8, 2018, the SEC settled an enforcement action against Voya Investments, LLC and Directed Services LLC (collectively, “Voya”) regarding Voya’s securities lending practices. The SEC found that Voya served as the investment adviser to various insurance-dedicated mutual funds and, for a period of almost 14 years, engaged in a practice of recalling securities loaned by those funds prior to their dividend record dates so that Voya’s insurance company affiliates, as the shareholders of record of the funds, could benefit
from tax deductions. The SEC found that, as a result, the funds, and individuals invested in them through their variable annuity policies, missed out on the securities lending income that the securities could have generated if they had not been recalled. The SEC further found that Voya failed to disclose this conflict of interest to the funds' board of directors or in the funds' prospectuses, which the SEC found “rendered the [f]unds' disclosures concerning securities lending materially misleading.” Without admitting or denying the SEC's findings, Voya agreed to settle this action and pay approximately $3.1 million in disgorgement and prejudgment interest and $500,000 in civil penalties.

F. Supreme Court Limits Scope of Anti-Retaliation Protections for Whistleblowers under Dodd-Frank

On February 21, 2018, the Supreme Court unanimously ruled that the anti-retaliation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) apply only to whistleblowers who first report the violation directly to the SEC. The case, Digital Realty Trust v. Somers, was filed by a former employee of the company who alleged that he was fired after internally reporting possible securities violations to the company's management. The plaintiff did not report the alleged violations to the SEC. The Court held that Dodd-Frank's definition of “whistleblower” is unambiguously limited to individuals who provide information to the SEC. Employees who only internally report violations are not whistleblowers under Dodd-Frank and do not gain its anti-retaliation protections.

However, because the Sarbanes-Oxley Act of 2002 defines a whistleblower more broadly than does Dodd-Frank, an employee who reports internally would be protected under Sarbanes-Oxley, but would remain unprotected under Dodd-Frank. In this case, Sarbanes-Oxley did not help the plaintiff because he failed to follow its administrative procedures for whistleblowers alleging retaliation.

The Court's ruling may have the unfortunate effect of incentivizing employees to report alleged securities violations directly to the SEC, since reporting internally would cause them to lose whistleblower status under Dodd-Frank.

G. LJM Funds Management Class Action Lawsuit

The recent collapse of an “alternative” fund has provoked several lawsuits. On February 5, 2018, the CBOE Volatility Index (“VIX”) moved twenty points, the largest one-day move in the index’s history, and its highest level in almost seven years. The VIX tracks the volatility of the S&P 500, as would be implied by the prices of options to buy or sell the S&P 500 index. Historically used as an indicator of market volatility, the VIX has recently become the reference
The Index had previously seen historically low levels until December 2017, when levels began to rise. As VIX-tracking products have grown in popularity, some have worried that trading in such products is causing the VIX to reflect supply of and demand for those products as well as measuring the implied volatility of the S&P 500.

On February 9, 2018, plaintiff shareholders brought a class action against LJM for securities fraud in Illinois District Court. The plaintiffs alleged that LJMIX left investors exposed to an “unacceptably high risk of catastrophic losses.” Specifically, the plaintiffs allege that the fund’s prospectus contained false and misleading statements because it claimed that the fund aimed to preserve capital. Yet, the fund allegedly had not taken appropriate steps to preserve capital in down markets. The plaintiffs claimed that these misstatements breached LJM’s duty of reasonable and diligent investigation. The plaintiffs also brought the same claims against individual trustees and officers and the portfolio managers.

The case was brought under 1933 Act Section 11 (liability for a materially false registration statement), Section 12 (selling by means of a materially false prospectus) and Section 15 (control person liability). It has since been followed by several more cases based on the same facts.

‡ In addition, an exchange-traded note ("ETN") issued by the Credit Suisse Group AG ("Credit Suisse") offered investors the ability to “short volatility” and earn returns that were the inverse of the VIX performance. On February 7, after sharp spikes in market volatility, the Credit Suisse ETN suffered severe losses and Credit Suisse announced that it would liquidate the ETN.
SEC Proposes Standard of Conduct for Broker-Dealers and Interpretation Regarding Standard of Conduct for Investment Advisers

SEC Approves Package of Proposed Rules and Interpretations Designed to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Investment Professionals

EXECUTIVE SUMMARY

On April 18, 2018, the Securities and Exchange Commission ("SEC") voted 4 to 1 (Commissioner Stein dissenting) to approve a package of proposed rules and interpretations with the stated goal of improving “the quality and transparency of investors’ relationships with investment advisers and broker-dealers while preserving investor access to a variety of advice relationships and investment products.”

The approximately 1,000-page package comprises three separate proposals:

(1) a proposed rule under the Securities Exchange Act of 1934 ("Exchange Act") establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer ("Regulation Best Interest");

(2) a proposed interpretation regarding the standard of conduct for investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act");

(3) proposed new and amended rules under the Advisers Act and the Exchange Act that, among other things, require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors in a mandatory disclosure form ("Form CRS") that summarizes key aspects of the relationship between such firms and their clients.

Regulation Best Interest: Proposed Regulation Best Interest would require a broker-dealer, or a natural person who is an associated person of a broker-dealer, to act in the best interest of a “retail customer” when making a recommendation of any securities transaction or investment strategy involving securities,
without placing the financial or other interest of the broker, dealer or natural person who is an associated person of a broker-dealer making the recommendation ahead of the interest of the retail customer. “Retail customer” is defined as a person (or its legal representative) who uses such a recommendation primarily for personal, family or household purposes. This “best interest” standard would be satisfied through compliance with certain disclosure, care, and conflict of interest mitigation obligations. The proposed rule would apply in addition to any other obligations under the Exchange Act and any other applicable provisions of the federal securities laws and related rules and regulations.

**Standard of Conduct for Investment Advisers:** The SEC’s proposed interpretation of the federal fiduciary standard applicable to investment advisers under Section 206 of the Advisers Act covers the scope and nature of an investment adviser’s duties of care and loyalty. The Investment Advisers Release states that the SEC believes that its interpretation is generally consistent with advisers’ current understanding of the practices necessary to comply with their fiduciary duty under the Advisers Act. In addition, the SEC has requested comment on whether it should impose additional legal obligations on investment advisers in a manner similar to those applicable to broker-dealers with respect to federal licensing and continuing education, provision of account statements and financial responsibility requirements.

**Form CRS Relationship Summary and Related Proposals:** The SEC’s proposed rule relating to Form CRS requires broker-dealers and investment advisers to deliver the customer relationship summary to retail investors at the beginning of a relationship and upon any material change in the relationship. Form CRS would set forth, among other things, information about the relationships and services a firm provides to retail investors, the applicable standard of conduct, fees and costs, the differences between brokerage and advisory services, and conflicts of interest (much of which would be language prescribed by the SEC). The SEC intends that Form CRS will supplement other more detailed disclosure and reporting requirements already required by the securities laws and related rules and regulations. This release also proposed new rules aimed at reducing investor confusion between investment adviser and broker-dealer services. Specifically, the proposed new rule would restrict broker-dealers and their financial professionals from using the terms “adviser” or “advisor” as part of their name or title and would require investment advisers and broker-dealers to disclose their registration status with the SEC in all written and electronic retail investor communications.

**Commissioner Reactions:** At the open meeting held on April 18, 2018, Commissioner Kara M. Stein, the sole dissenter for each proposal, referred to the proposals as “Regulation Status Quo” and commented that, in her view, the proposals are inadequate for the protection of retail investors who continue to suffer confusion about the relationships and obligations of the investment professionals they engage. Commissioner Stein also expressed displeasure at the continuing ambiguity of the “best interest” standard as proposed in Regulation Best Interest. Commissioners Robert J. Jackson, Jr. and Hester M.
Peirce, who supported issuing the proposed package for public comment, stopped short, however, of expressing support for the proposals themselves.\(^7\)

**Next Steps:** The SEC is seeking comment from the public on all aspects of nearly every feature in the three proposals and has included over 450 questions on more than 40 topics. Comments are due by August 7, 2018.

The package of proposed rules and interpretations, which is extensive, will need to be reviewed and considered carefully by broker-dealers, investment advisers and investment professionals and their advisers. Taken as a whole, proposed Regulation Best Interest and Form CRS would impose meaningful additional disclosure and compliance obligations on impacted firms. Various requirements are detailed and prescriptive—going so far as to specify the font type and size of certain required disclosures—and could easily result in violations if firms are not carefully monitoring their compliance with these requirements. Commenters should consider addressing specific aspects of the proposals that could impose undue compliance burdens.

Although thoughtfully written, the SEC’s proposed interpretation regarding the standard of conduct for investment advisers under the Advisers Act appears to introduce some uncertainty as to whether disclosure alone may be sufficient for an investment adviser to comply with its fiduciary duties in appropriate circumstances. This would be at odds with the long-standing legal principle that an investment adviser must *either* eliminate or expose all conflicts of interest that might incline the investment adviser to render advice that is not disinterested.\(^8\) The Investment Advisers Release also creates a risk of requiring investment advisers to develop separate tiers of clients based on each client’s relative sophistication and ability to understand the investment adviser’s disclosed conflicts of interest. Commenters may wish to focus on the legal principles governing investment advisers’ fiduciary duties and the role of disclosure in their relationships with clients.

This memorandum summarizes the key aspects of the SEC’s package of proposed rules and interpretations.
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Annex A : Hypothetical Relationship Summaries Prepared by SEC Staff .......................................... A-1
In its release titled “Regulation Best Interest” (Release No. 34-83062; File No. S7-07-18) (the “Regulation Best Interest Release”), the SEC proposed a new rule under the Securities Exchange Act of 1934 (“Exchange Act”) that would establish a standard of conduct for a broker-dealer and natural persons who are associated persons of a broker-dealer (together, a “broker-dealer”) when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.9

A. BACKGROUND

The Exchange Act and self-regulatory organization (“SRO”) rules provide a comprehensive regulatory framework that governs the obligations that attach when a broker-dealer makes a recommendation to a customer. For instance, under existing federal securities laws and SRO rules, broker-dealers have a duty of fair dealing,10 which requires broker-dealers to make only suitable recommendations to customers and to receive fair and reasonable compensation.11 Nevertheless, these various conduct obligations have not required broker-dealers to make recommendations that are in a client’s “best interest.”

Over the past decade, concerns about the potentially harmful effects of broker-dealer conflicts of interest have drawn the increasing scrutiny of Congress and various governmental agencies, including, among others, the SEC and the U.S. Department of Labor (“DOL”), as well as SROs such as the Financial Industry Regulatory Authority (“FINRA”).

For instance, Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), required the SEC to undertake a study to evaluate “the effectiveness of existing legal or regulatory standards of care (imposed by the SEC, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers” and “whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.”12

In January 2011, the SEC issued the study (the “913 Study”)13 mandated by Section 913 of the Dodd-Frank Act. The 913 Study recommended that the SEC adopt and implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers who provide personalized investment advice about securities to retail investors. The 913 Study recommended a standard of conduct that would require firms “to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.”14 Subsequently, in March 2013, the SEC issued a public request for data and other information in order to evaluate the standards of conduct and regulatory obligations applicable to broker-dealers and investment advisers.15 The SEC received more than 250
responses that expressed general support for a uniform fiduciary standard of conduct, although there was no consensus on what this standard should encompass.  

In November 2013, the SEC’s Investment Advisory Committee (“IAC”) recommended, among other proposals, implementing a uniform fiduciary standard either through (i) a narrowing of the broker-dealer exclusion from the definition of “investment adviser” under the Advisers Act (see Section I.F) or (ii) new rules under Section 913 of the Dodd-Frank Act to adopt a principles-based fiduciary duty and to permit certain sales-related conflicts only upon full disclosure and appropriate management.

Meanwhile, beginning in 2010, the DOL had engaged in rulemaking to specify the definition of “fiduciary” in connection with the provision of investment advice under the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Internal Revenue Code of 1986 (“Code”).  

In April 2016, the DOL adopted a new rule (“DOL Fiduciary Rule”) that would treat as a “fiduciary” any person who provides investment advice or recommendations for compensation with respect to assets of an ERISA plan or an Individual Retirement Account (“IRA”). The DOL Fiduciary Rule broadly expanded the circumstances in which broker-dealers would be subject to the prohibited transaction provisions of ERISA and the Code. One of the effects of the broad nature of the DOL Fiduciary Rule was that broker-dealers would be prohibited from engaging in purchases and sales for their own account (i.e., engaging in principal transactions) and from receiving compensation from third parties (including transaction-based fees, a common form of broker-dealer compensation) in connection with transactions involving an ERISA plan or IRA. To avoid this result, which could effectively eliminate a broker-dealer’s ability or willingness to provide investment advice with respect to investors’ retirement assets, the DOL published two exemptions from the prohibited transaction provisions:

- the Best Interest Contract Exemption (“BIC Exemption”); and
- the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plan and IRAs (“Principal Transactions Exemption”).

The BIC Exemption and the Principal Transactions Exemption would allow persons deemed fiduciaries under the DOL Fiduciary Rule to receive compensation and to engage in certain principal transactions that would otherwise be prohibited transactions. Under a two-phase approach, the revised definition of “fiduciary” under the DOL Fiduciary Rule as well as certain standards of impartial conduct under the BIC Exemption became effective on June 9, 2017, while compliance with the remaining conditions of the BIC Exemption and the Principal Transactions Exemption would not be required until July 1, 2019. However, on March 15, 2018, the United States Court of Appeals for the Fifth Circuit vacated in toto the DOL Fiduciary Rule, citing a conflict with the statutory text of ERISA and the Code and admonishing the DOL for infringing on the SEC’s regulatory mandate under the Dodd-Frank Act. The DOL’s opportunity to appeal the decision expired on April 30, 2018. On May 7, 2018 the DOL issued a Field Assistance Bulletin describing the DOL’s temporary enforcement policy related to the DOL Fiduciary Rule, indicating
that “from June 9, 2017, until after regulations or exemptions or other administrative guidance has [sic] been issued, the [DOL] will not pursue prohibited transactions claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the BIC Exemption and Principal Transactions Exemption, or treat such fiduciaries as violating the applicable prohibited transaction rules.”

In June 2017, the SEC had sought public comment on a variety of issues associated with standards of conduct for investment professionals. The SEC received approximately 250 comments which suggested, among other things, that due to the complex and burdensome requirements imposed as part of the BIC Exemption and the associated litigation risk, broker-dealers were changing the types of products and accounts offered to retirement investors. The comments also expressed concerns that retirement investors would be harmed through reduced product choice, increased cost for retirement advice, or lost or restricted access to advice.

The table below summarizes the key events leading up to the proposed Regulation Best Interest.

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Outcome</th>
</tr>
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<tbody>
<tr>
<td>July 2010</td>
<td>Enactment of Dodd-Frank Act</td>
<td>Section 913 mandates SEC Study relating to personalized investment advice and recommendations about securities to retail customers.</td>
</tr>
<tr>
<td>January 2011</td>
<td>913 Study</td>
<td>The 913 Study recommended SEC adoption and implementation of uniform fiduciary standard of conduct for broker-dealers and investment advisers.</td>
</tr>
<tr>
<td>March 2013</td>
<td>SEC Request for Comment</td>
<td>The SEC received approximately 250 comments that expressed general support for proposals of 913 Study.</td>
</tr>
<tr>
<td>November 2013</td>
<td>IAC Recommendation</td>
<td>The IAC recommended two options for SEC action in respect of proposals of 913 Study.</td>
</tr>
<tr>
<td>April 2016</td>
<td>DOL Rulemaking</td>
<td>The DOL Fiduciary Rule and certain standards of conduct became effective on June 9, 2017; compliance with conditions of certain exemptions to DOL Fiduciary Rule was delayed until July 1, 2019.</td>
</tr>
<tr>
<td>June 2017</td>
<td>SEC Request for Comment</td>
<td>The SEC received approximately 250 comments that were considered in drafting Regulation Best Interest.</td>
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</table>
According to the SEC, Proposed Regulation Best Interest is intended to address the ambiguity surrounding the standard of conduct under the current regulatory framework applicable to broker-dealers under the Exchange Act and SRO rules.

**B. OVERVIEW OF REGULATION BEST INTEREST**

Proposed Regulation Best Interest would establish a standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. It is intended to apply in addition to any obligations under the Exchange Act, along with any rules the SEC may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. Further, proposed Regulation Best Interest is intended to be consistent with and build upon relevant SRO rules and the existing regulatory regime. Proposed Regulation Best Interest and its specific obligations would not apply to advice provided by an investment adviser or a dual-registrant acting in the capacity of an investment adviser (further discussed in I.C.4 below).

The standard of conduct for broker-dealers under the proposed Regulation Best Interest is:

> to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer.

The Regulation Best Interest Release notes that, in developing proposed Regulation Best Interest, the SEC has drawn from principles that apply to the provision of investment advice under other regulatory regimes—including SRO rules, state common law, the Advisers Act, the standards set forth in Section 913(g) of the Dodd-Frank Act, the 913 Study recommendations and any duties that would apply to broker-dealers as a result of the DOL Fiduciary Rule and the related BIC Exemption and Principal Transactions Exemption.
The table below briefly summarizes the applicable standards of conduct under the 913 Study, the DOL Fiduciary Rule, the BIC Exemption to the DOL Fiduciary Rule, the Advisers Act and proposed Regulation Best Interest.

<table>
<thead>
<tr>
<th>Standards of Conduct for Broker-Dealers and Investment Advisers</th>
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<tr>
<td><strong>913 Study</strong></td>
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<tr>
<td><strong>DOL Fiduciary Rule</strong></td>
</tr>
<tr>
<td><strong>BIC Exemption to DOL Fiduciary Rule</strong></td>
</tr>
<tr>
<td><strong>Investment Advisers Act</strong></td>
</tr>
<tr>
<td><strong>Proposed Regulation Best Interest</strong></td>
</tr>
</tbody>
</table>

As shown in the table above, the standard of conduct proposed for Regulation Best Interest departs from the standard proposed by the SEC in the 913 Study for broker-dealers as it replaces the phrase “without regard to the financial or other interest” with the phrase “without placing the financial or other interest… ahead of the interest of the retail customer.” In the Regulation Best Interest Release, the SEC expressed...
concern that the “without regard to” language could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts, which is not its intention. Rather, the SEC acknowledges in the Regulation Best Interest Release that conflicts of interest are inherent in any principal-agent relationship. Despite using different language, the SEC believes its proposal reflects the underlying intent of previous standards of conduct: although a broker-dealer’s financial interests can and will inevitably exist, they cannot be the predominant motivating factor behind a recommendation to an investor.

The SEC has proposed that the “best interest” standard under Regulation Best Interest will be met upon satisfaction by a broker-dealer of the following obligations:

- **Disclosure Obligation:** the broker-dealer, prior to or at the time of making a recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, including all material conflicts of interest that are associated with the recommendation.

- **Care Obligation:** the broker-dealer, in making the recommendation, exercises reasonable diligence, care, skill, and prudence.

- **Conflict of Interest Obligations:**
  - the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with a recommendation of any securities transaction or investment strategy involving securities to a retail customer; and
  - the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

The SEC notes in the Regulation Best Interest Release that scienter would not be required to establish a violation of proposed Regulation Best Interest—thus, any failure to comply with the specific obligations would result in a violation. Further discussion of each of these obligations is set forth in Section I.D below.

As proposed, a broker-dealer would not be able to waive compliance with proposed Regulation Best Interest, nor could a retail customer agree to waive his or her protection under proposed Regulation Best Interest. In other words, the scope of proposed Regulation Best Interest cannot be reduced by contract. However, a broker-dealer may agree with a retail customer by contract to take on additional obligations beyond those imposed by proposed Regulation Best Interest, such as agreeing to hold itself to a fiduciary standard or provide ongoing monitoring for purposes of recommending changes in investments.

The SEC states that it does not intend proposed Regulation Best Interest to create a new private right of action or right of rescission.

It is important to note that proposed Regulation Best Interest focuses solely on enhancements to the broker-dealer regulatory regime. It is intended to be separate and distinct from the fiduciary standard applicable to investment advisers under the Advisers Act. A discussion of the SEC’s historical
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interpretations of the scope and nature of an investment adviser’s fiduciary obligations, as well as its proposed interpretation, under the Advisers Act is set forth in Section II below.

C. KEY TERMS AND SCOPE OF BEST INTEREST OBLIGATION

1. “Best Interest”

In the Regulation Best Interest Release, the SEC has not defined “best interest.” Instead, it proposed that a determination of whether a broker-dealer acted in the best interest of a retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the component obligations under proposed Regulation Best Interest are satisfied. As shown in the table below, certain practices would not be per se prohibited by proposed Regulation Best Interest to the extent broker-dealers satisfy the component obligations thereunder.

<table>
<thead>
<tr>
<th>Practices Not Per Se Prohibited under Proposed Regulation Best Interest</th>
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<tbody>
<tr>
<td>• Charging commissions or other transaction-based fees</td>
</tr>
<tr>
<td>• Receiving or providing differential compensation based on the product sold</td>
</tr>
<tr>
<td>• Receiving third-party compensation</td>
</tr>
<tr>
<td>• Recommending proprietary products, products of affiliates or a limited range of products</td>
</tr>
<tr>
<td>• Recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings (“IPOs”)</td>
</tr>
<tr>
<td>• Recommending that a transaction be executed in a principal capacity</td>
</tr>
<tr>
<td>• Recommending complex products</td>
</tr>
<tr>
<td>• Allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer’s own account</td>
</tr>
<tr>
<td>• Considering cost to the broker-dealer of effecting the transaction or strategy on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security)</td>
</tr>
<tr>
<td>• Accepting a retail customer’s order that is contrary to the broker-dealer’s recommendations</td>
</tr>
</tbody>
</table>

2. “When Making a Recommendation,” “At Time a Recommendation Is Made”

The SEC has proposed that Regulation Best Interest would apply when a broker-dealer is making a recommendation about any securities transaction or investment strategy to a retail customer. “Recommendation” would have the same meaning as the term is currently interpreted under federal securities laws and SRO rules. Consistent with existing broker-dealer regulation, the SEC’s view of
whether a recommendation has been given will turn on the facts and circumstances of the particular situation. In determining whether a broker-dealer has made a recommendation for the purposes of proposed Regulation Best Interest, the SEC points to factors that have historically been considered in the context of broker-dealer suitability obligations, such as whether a communication “reasonably could be viewed as a call to action” and “reasonably would influence an investor to trade a particular security or group of securities.” Examples of communications that would not rise to the level of a recommendation include providing general investor education (e.g., a brochure discussing asset allocation strategies) or limited investment analysis (e.g., a retirement savings calculator). Consistent with existing interpretations and guidance on what constitutes a recommendation, the proposed Regulation Best Interest obligation would also apply to activity that has been interpreted as “implicit recommendations,” such as through a broker-dealer’s execution of discretionary transactions or making a recommendation to a brokerage customer in a non-discretionary account.

The Regulation Best Interest obligation would be triggered each time a recommendation is made by a broker-dealer to a retail customer. The obligation would not:

- extend beyond a particular recommendation or generally require a broker-dealer to have a continuous duty to a retail customer or to impose a duty to monitor the performance of the account;
- require the broker-dealer to refuse to accept a customer’s order that is contrary to a broker-dealer’s recommendation; or
- apply to self-directed or otherwise unsolicited transactions by a retail customer.

3. “Any Securities Transaction or Investment Strategy”

Proposed Regulation Best Interest would apply to recommendations of any securities transaction, whether a sale, purchase or exchange, and of any investment strategy involving securities to retail customers. The obligation is not proposed to extend to recommendations of account types generally, unless the recommendation is tied to a securities transaction (e.g., rollovers or transfers of assets into ERISA accounts and IRAs).

4. “Retail Customer”

“Retail Customer” would be defined as “a person, or the legal representative of such person, who (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes.” This definition generally tracks the definition of “retail customer” under Section 913(a) of the Dodd-Frank Act. However, it should be noted that the definition of “retail customer” differs from the definition of “retail investor” in Form CRS (see Section III below).
“Retail Customer” in Proposed Regulation Best Interest

A person, or the legal representative of such person, who:

- (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- (2) uses the recommendation primarily for personal, family, or household purposes.

“Retail Investor” in Form CRS

A prospective or existing client or customer who is a natural person, regardless of the individual’s net worth. This could include:

- accredited investors,
- qualified clients, and
- qualified purchasers.

5. Application to Investment Advisers and Dual-Registrants

The SEC intends for Regulation Best Interest to apply only in the context of a brokerage relationship with a brokerage customer. Accordingly, proposed Regulation Best Interest would not apply to the relationship between an investment adviser and its advisory client (or any recommendations made by an investment adviser to an advisory client).

Somewhat more complicated is the application of proposed Regulation Best Interest to dual-registrants. The SEC proposes that Regulation Best Interest would apply to a dual-registrant only when it is making a recommendation in its capacity as a broker-dealer. Proposed Regulation Best Interest would not apply to advice provided by a dual-registrant when acting in the capacity of an investment adviser, even if the person to whom the recommendation is made also has a brokerage relationship with the dual-registrant or even if the dual-registrant subsequently executes the transaction in its capacity as a broker-dealer.

If a “retail customer” is receiving a recommendation from:

<table>
<thead>
<tr>
<th>If a “retail customer” is receiving a recommendation from:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A broker-dealer…</td>
<td>Regulation Best Interest applies.</td>
</tr>
<tr>
<td>An investment adviser…</td>
<td>Regulation Best Interest does not apply.</td>
</tr>
<tr>
<td>A dual-registrant…</td>
<td>Regulation Best Interest applies only when the recommendation is made in the registrant’s capacity as a broker-dealer; it does not apply when the recommendation is made in the registrant’s capacity as an investment adviser.</td>
</tr>
</tbody>
</table>

Determining whether a recommendation made by a dual-registrant is in its capacity as broker-dealer requires a facts and circumstances analysis. Factors that should be considered include the type of account (e.g., advisory or brokerage), how the account is described, the type of compensation, and the
extent to which the dual-registrant made clear the capacity in which it was acting to the customer or client. Where a dual-registrant acts in the capacity of an investment adviser, and is therefore not subject to proposed Regulation Best Interest, the adviser would be required to comply with its fiduciary obligations under the Advisers Act, as described in more detail in Section II below.

D. COMPONENTS OF REGULATION BEST INTEREST

The obligation to “act in the best interest of the retail customer… without placing the financial or other interest of the [broker-dealer] ahead of the retail customer” would be satisfied if the broker-dealer complies with four component obligations: a Disclosure Obligation, a Care Obligation, and two Conflict of Interest Obligations. In order to provide greater clarity to broker-dealers about the requirements of the best interest standard of conduct, Regulation Best Interest as proposed would not impose any obligations other than these four specified obligations.

1. Disclosure Obligation

The Disclosure Obligation would require that a broker-dealer “prior to or at the time of [a] recommendation, reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation.” The Disclosure Obligation under proposed Regulation Best Interest and the requirements of Form CRS (discussed in Section III.A below) are designed to complement and build upon each other. 34

Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer

The Disclosure Obligation would apply to any “material facts relating to the scope and terms of the relationship with the retail customer.” Some examples include:

- whether the broker-dealer is acting in a broker-dealer capacity at the time of the recommendation; 35
- the fees and charges that apply to the retail customer’s transactions, holdings, and accounts; and
- the type and scope of services provided by the broker-dealer, including, e.g., monitoring the performance of the retail customer’s account.

While the examples above reflect what the SEC believes would generally be material facts regarding the scope and terms of the relationship, broker-dealers would need to determine if any other material facts relate to the scope and terms of the relationship based on the facts and circumstances.

Material Conflicts of Interest Associated with the Recommendation

The Disclosure Obligation would apply to any “material conflict of interest,” which would be defined as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested. The SEC notes in the Regulation
Best Interest Release that its proposed interpretation is based on SEC precedent under the Advisers Act as the SEC believes it is appropriate to interpret the term in accordance with existing and well-established SEC precedent. The SEC indicates in the Regulation Best Interest Release that material conflicts associated with recommendations relating to the following should be disclosed:

- proprietary products, products of affiliates, or a limited range of products;
- one share class versus another share class of a mutual fund;
- securities underwritten by the firm or a broker-dealer affiliate;
- the rollover or transfer of assets from one type of account to another (including, e.g., recommendations to roll over or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction); and
- allocation of investment opportunities among retail customers (e.g., IPO allocation).

A broker-dealer should also consider whether any material conflicts arise from financial incentives that would need to be disclosed and mitigated, including those associated with:

- compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold;
- employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews);
- compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third parties (e.g., sub-accounting or administrative services provided to a mutual fund);
- receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third party;
- sales of proprietary products or services, or products of affiliates; and
- transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.

The Disclosure Obligation would apply to the extent a broker-dealer determines to disclose and not eliminate a material conflict of interest pursuant to the Conflict of Interest Obligations (described in Section I.D.3 below).

Form, Timing and Method of Delivery
In order to provide flexibility to broker-dealers, proposed Regulation Best Interest would not mandate the form, specific timing or method for delivering disclosure pursuant to the Disclosure Obligation, other than the general requirement that the disclosure be made “prior to or at the time” of the recommendation.
### Possible Timing and Frequency of Disclosure

<table>
<thead>
<tr>
<th>Possible Timing and Frequency of Disclosure</th>
<th>Timing and Frequency of Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At the beginning of a relationship</strong></td>
<td>e.g., in a relationship guide (such as or in addition to Form CRS) or in written communications with the retail customer (such as the account opening agreement)</td>
</tr>
<tr>
<td><strong>On a regular or periodic basis</strong></td>
<td>e.g., on a quarterly or annual basis, when any previously disclosed information becomes materially inaccurate, or when there is new relevant material information</td>
</tr>
<tr>
<td><strong>At other specified instances</strong></td>
<td>e.g., before making a particular recommendation or at the point of sale</td>
</tr>
<tr>
<td><strong>At multiple instances during the relationship</strong></td>
<td>(see above)</td>
</tr>
</tbody>
</table>

### Reasonable Disclosure

In order to “reasonably disclose” material facts relating to the scope and terms of the relationship, a broker-dealer would need to give sufficient information to a retail customer to enable him or her to make an informed decision with regard to the recommendation, which would need to be determined on a case-by-case basis. Compliance with the Disclosure Obligation would be measured against a negligence standard instead of strict liability.

#### 2. Care Obligation

The Care Obligation generally draws from principles similar to those underlying DOL’s “best interest” Impartial Conduct Standard, as described by DOL in the BIC Exemption, and echoes the general suitability, customer-specific suitability and series-of-transactions suitability determinations required by FINRA Rule 2111.05.

In making the recommendation, the broker-dealer “must exercise reasonable diligence, care, skill, and prudence” to satisfy the obligations outlined in the table below.
<table>
<thead>
<tr>
<th>Care Obligation</th>
<th>Methods of Satisfying Obligation</th>
</tr>
</thead>
<tbody>
<tr>
<td>“(1) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers.”</td>
<td>• Undertaking reasonable diligence by considering factors such as the costs, investment objectives, characteristics associated with a product or strategy, liquidity, risks and potential benefits, volatility, likely performance of market and economic conditions, the expected return of the security or investment strategy, and the financial and other benefits to the broker-dealer; and</td>
</tr>
<tr>
<td>“(2) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer’s investment profile and the potential risks and rewards associated with the recommendation.”</td>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of at least some retail customers based on that understanding.</td>
</tr>
<tr>
<td>• Undertaking reasonable diligence by considering factors such as the costs, investment objectives and characteristics associated with a product or strategy, and the financial and other benefits to the broker-dealer;</td>
<td>• Undertaking reasonable diligence to ascertain the retail customer's investment profile, which includes, but is not limited to, the retail customer’s:</td>
</tr>
<tr>
<td>• Undertaking reasonable diligence to ascertain the retail customer’s investment profile, which includes, but is not limited to, the retail customer’s:</td>
<td>• age;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• other investments;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• financial situation and needs;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• tax status;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• investment objectives;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• investment experience;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• investment time horizon;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• liquidity needs;</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• risk tolerance; and</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• other information disclosed to the broker-dealer in connection with a recommendation; and</td>
</tr>
<tr>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
<td>• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.</td>
</tr>
</tbody>
</table>
The Care Obligation encourages the broker-dealer to consider any reasonable alternatives in determining whether it has a reasonable basis for making the recommendation. Under this approach, a broker-dealer would not be expected to analyze all possible securities, all other products or all investment strategies. Further, as long as the Care Obligation is satisfied and associated conflicts are disclosed or eliminated (see Section I.D.3 below), proposed Regulation Best Interest does not prohibit recommendations from a limited range of products, or recommendations of proprietary products, products of affiliates, or principal transactions.

Further, the Care Obligation goes beyond a broker-dealer’s existing suitability obligations derived from the antifraud provisions of the federal securities laws; for instance, a violation of the suitability obligation requires an element of fraud or deceit, whereas the Care Obligation does not. Thus, a key difference resulting from the obligations imposed by proposed Regulation Best Interest as compared to a broker-dealer’s existing suitability obligations under the antifraud provisions of the federal securities laws is that a broker-dealer would not be able to satisfy its Care Obligation through disclosure alone.

In addition, the Regulation Best Interest Release indicates that the SEC would consider the cost of the security or strategy and any associated financial incentives as the more important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy under the Care Obligation. Other factors that would be important include the product’s or strategy’s investment objectives, certain characteristic features, liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions.

It should be noted that proposed Regulation Best Interest would not necessarily obligate a broker-dealer to recommend the “least expensive” or the “least remunerative” security or investment strategy, provided that the broker-dealer complies with the Disclosure, Care and Conflict of Interest Obligations. Still, under the Care Obligation, a broker-dealer could not be expected to have a reasonable basis to believe that a
recommended security is in the best interest of a retail customer if it is more costly than a reasonably available alternative offered by the broker-dealer and the characteristics of the securities are otherwise identical.

3. **Conflict of Interest Obligations**

The Conflict of Interest Obligations would require a broker-dealer to:

- establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate, all material conflicts of interest that are associated with recommendations covered by Regulation Best Interest; and
- establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

A principles-based approach to the Conflict of Interest Obligations allows broker-dealers the flexibility to establish a supervisory system in a manner that best reflects their business practices. For instance, the SEC would deem it reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance with the Conflict of Interest Obligations, rather than conducting a detailed review of each recommendation of a securities transaction or security-related investment strategy to a retail customer.

In the SEC’s view, so long as a broker-dealer’s policies and procedures are reasonably designed to meet its Conflict of Interest Obligations, the broker-dealer would be permitted to exercise its own judgment as to whether the conflict can be effectively disclosed (as discussed in Section I.D.1), to determine what conflict mitigation methods may be appropriate and to determine whether or how to eliminate a conflict. Whether a broker-dealer’s policies and procedures are reasonably designed would depend on the relevant facts and circumstances.

In the Regulation Best Interest Release, the SEC encourages broker-dealers to consider developing policies and procedures outlining:

- how the firm identifies its material conflicts of interest, clearly identifying all such material conflicts of interest and specifying how the broker-dealer intends to address each conflict;
- the firm’s compliance review and monitoring systems;
- processes to escalate identified instances of noncompliance to appropriate personnel for remediation;
- procedures that clearly designate responsibility to business lines personnel for supervision of functions and persons, including determination of compensation;
- processes for escalating conflicts of interest;
- processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures; and
- training on the policies and procedures.
E. RECORDKEEPING AND RETENTION

Exchange Act Section 17(a)(1) requires registered broker-dealers to make and keep for prescribed periods such records as the SEC deems “necessary or appropriate in the public interest, for the protection of investors.” Exchange Act Rules 17a-3 and 17a-4 specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept, respectively.

As shown in the table below, the SEC has proposed certain amendments to Rules 17a-3 and 17a-4 under Regulation Best Interest.

<table>
<thead>
<tr>
<th>Current Rule</th>
<th>Proposed Amendment under Regulation Best Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rule 17a-3(a)(17)</td>
<td>Requires broker-dealers that make recommendations for accounts with a natural person as customer or owner to create and periodically update customer account information. Adds new paragraph (a)(25) which would require, for each retail customer to whom a recommendation will be provided, a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest, as well as the identity of each natural person who is an associated person of a broker or dealer, if any, responsible for the account.</td>
</tr>
<tr>
<td>Rule 17a-4(e)(5)</td>
<td>Requires broker-dealers to maintain and preserve in an easily accessible place all account information required pursuant to Rule 17a-3(a)(17) for six years. Would require broker-dealers to retain any information that the retail customer provides to the broker-dealer or the broker-dealer provides to the retail customer pursuant to proposed Rule 17a-3(a)(25), in addition to the existing requirement to retain information obtained pursuant to Rule 17a-3(a)(17).</td>
</tr>
</tbody>
</table>

Thus, the proposed amendments to Rule 17a-3(a)(17) and Rule 17a-4(e)(5) would require broker-dealers to retain all of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for six years.
F. WHETHER THE EXERCISE OF INVESTMENT DISCRETION SHOULD BE VIEWED AS SOLELY INCIDENTAL TO THE BUSINESS OF A BROKER OR DEALER

The Advisers Act regulates the activities of certain “investment advisers,” defined in Section 202(a)(11) of the Advisers Act as persons who engage in the business of advising others about securities for compensation. Section 202(a)(11)(C) excludes from the definition of “investment adviser” a broker-dealer whose performance of such advisory services is solely incidental to the conduct of his business as a broker-dealer and who receives no special compensation for those services (the “broker-dealer exclusion”).

In 2005, the SEC adopted an interpretive rule that, among other things, provided that broker-dealers are excluded from the Advisers Act for any accounts over which they exercise only temporary or limited investment discretion. In 2007, this rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on the grounds that the SEC lacked authority for expanding the exclusion under Section 202(a)(11)(C) of the Advisers Act.

While a broker-dealer’s ability to engage in discretionary activity is currently circumscribed by existing rules under the federal securities laws, SROs and state laws, in light of both proposed Regulation Best Interest and proposed Form CRS, the SEC is requesting public comment to consider the scope of the broker-dealer exclusion and whether a broker-dealer’s provision of certain discretionary investment advice should be considered solely incidental to the conduct of the person’s business as a broker-dealer.

II. INTERPRETATION OF STANDARD OF CONDUCT FOR INVESTMENT ADVISERS

In its release titled “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation” (Release No. IA-4889; File No. S7-09-18) (the “Investment Advisers Release”), the SEC has proposed an interpretation of the standard of conduct for investment advisers under the Advisers Act. The SEC’s stated purpose in issuing the Investment Advisers Release is to “reaffirm – and in some cases clarify” certain aspects of the fiduciary duty that an investment adviser owes to its clients under Section 206 of the Advisers Act. Although the SEC elected not to propose a uniform standard of conduct for broker-dealers and investment advisers as recommended by the 913 Study, the SEC notes that it continues to consider whether it can improve protection of investors through potential enhancements to the legal obligations of investment advisers.

The Investment Advisers Release reaffirms that, unlike broker-dealers, an investment adviser owes a fiduciary duty to its clients under Section 206 of the Advisers Act. Although the fiduciary duty to which investment advisers are subject is not specifically defined in the Advisers Act or in SEC rules, equitable common law principles and Congressional intent reflect a requirement that an investment adviser, at all times, serve the best interest of its clients and not subordinate its clients’ interest to its own.
As discussed further below, the SEC has interpreted the fiduciary duty under the Advisers Act as comprised of a duty of care and a duty of loyalty, which include an affirmative duty of utmost good faith and full and fair disclosure of all material facts. The SEC notes in the Investment Advisers Release that “the investment adviser cannot disclose or negotiate away, and the investor cannot waive, this federal fiduciary duty.” Although the fiduciary duty cannot be waived, the Investment Advisers Release appears to introduce some uncertainty as to whether disclosure alone may be sufficient for an investment adviser to comply with its fiduciary duties in appropriate circumstances, which would be at odds with the long-standing principle that an investment adviser must either eliminate or expose all conflicts of interest that might incline the investment adviser to render advice that is not disinterested. Indeed, the Investment Advisers Release itself (as discussed in Section B below) and prior SEC interpretations and case law indicate that full and fair disclosure alone may be sufficient in certain cases for an investment adviser to comply with its fiduciary duties.

The Investment Advisers Release states that the SEC believes that the interpretations set forth therein are generally consistent with investment advisers’ current understanding of the practices necessary to comply with their fiduciary duty under the Advisers Act; however, the SEC notes that “there may be certain current investment advisers who have interpreted their fiduciary duty to require something less, or something more, than the Commission’s interpretation.” The SEC notes that the interpretation is not intended to be the exclusive resource for understanding the principles relevant to an adviser’s fiduciary duty.

The table below summarizes the key differences in the standard of conduct that would apply to investment advisers and broker-dealers under the proposed rules and interpretations.

<table>
<thead>
<tr>
<th>Standard of Conduct</th>
<th>Type of Client to Which Standard Applies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Advisers</strong></td>
<td>All clients</td>
</tr>
<tr>
<td>Investment advisers owe a <strong>fiduciary</strong> duty to serve the best interest of the client, which includes an obligation not to subrogate the clients’ interest to its own</td>
<td></td>
</tr>
<tr>
<td><strong>Broker-Dealers Under Proposed Regulation Best Interest</strong></td>
<td>“Retail customers” as defined in proposed Regulation Best Interest</td>
</tr>
<tr>
<td>Broker-dealers must act in the <strong>best interest</strong> of the client at the time of making a recommendation without placing the financial or other interest of the broker-dealer ahead of the interest of the client by satisfying the specific obligations set forth in proposed Regulation Best Interest</td>
<td></td>
</tr>
</tbody>
</table>
A. DUTY OF CARE

As fiduciaries, investment advisers owe their clients a duty of care. The SEC has indicated that the duty of care includes, among other things:

- the duty to act and to provide advice that is in the best interest of the client;
- the duty to seek best execution of a client’s transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and
- the duty to provide advice and monitoring over the course of the relationship.

1. Duty to Provide Advice that Is in the Client’s Best Interest

In the context of providing personalized investment advice, the SEC interprets the duty of care as including a duty to make a reasonable inquiry into a client’s financial situation, level of financial sophistication, investment experience, and investment objectives (referred to collectively as the client’s “investment profile”) and a duty to provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile.

According to the SEC, the nature and extent of the adviser's inquiry into the client’s investment profile will necessarily turn on what is reasonable under the circumstances, including the nature of the agreed-upon advisory services, the nature and complexity of the anticipated investment advice, and the investment profile of the client. An adviser is expected to update a client's investment profile in order to adjust its advice to reflect any changed circumstances.

An investment adviser must also have a reasonable belief that the personalized advice is suitable for and in the best interest of the client based on the client's investment profile. Important factors to consider when determining whether a security or investment strategy involving a security is in the best interest of the client include the cost (including fees and compensation) associated with investment advice, the investment product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. The SEC’s interpretation of the duty of care requires that advisers conduct a reasonable investigation into an investment sufficient that its advice is not based on materially inaccurate or incomplete information.

The Investment Advisers Release specifically notes that cost is just one of a number of factors to be considered by advisers and, while generally an important factor, the fiduciary duty does not necessarily require an adviser to recommend the lowest-cost investment product or strategy to a client. In the SEC’s view, an adviser would not satisfy its fiduciary duty to provide advice that is in the client’s best interest by simply advising its client to invest in the least expensive or least remunerative investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's investment profile.
2. Duty to Seek Best Execution

In a situation where an investment adviser has the responsibility to select the broker-dealer(s) to execute client trades, an adviser has the duty to seek best execution of a client's transactions.55 In order to meet this obligation, an investment adviser must seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances. The adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. In the SEC’s view, maximizing value can encompass more than just minimizing cost and the determinative factor for maximizing is whether the transaction represents the best qualitative execution.56

3. Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship

The SEC has interpreted the duty of care of an investment adviser as encompassing a duty to provide advice and monitoring over the course of a relationship with a client.57 An adviser is, therefore, required to provide advice and services to a client over the course of the relationship at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client.

B. DUTY OF LOYALTY

The duty of loyalty requires an investment adviser to put its client’s interests first.58 The SEC’s view is that this duty requires not only that an investment adviser not favor its own interests over those of a client, but also that the adviser not unfairly favor one client over another.59 The SEC notes that the duty does not go so far as to require an adviser to have a pro rata allocation policy among clients, but allocation policies must be fair and, if they present a conflict, the adviser must fully and fairly disclose the conflict such that a client can provide informed consent.

In seeking to meet its duty of loyalty, an adviser must also make full and fair disclosure to its clients of all material facts relating to the advisory relationship and must seek to avoid conflicts of interest with its clients.60 Disclosure must be clear and detailed enough for a client to make a reasonably informed decision about whether to provide informed consent to such conflicts.

The SEC notes in the Investment Advisers Release that disclosure of a conflict alone will not always be sufficient to satisfy the adviser’s duty of loyalty and Section 206 of the Advisers Act.61 In the SEC’s opinion, disclosure will not have a prophylactic effect where (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict or (ii) the nature and extent of the conflict mean that it would be difficult to provide disclosure that adequately conveys in a manner understandable to the client the potential effect of the conflict.62 Where full and fair disclosure and informed consent are insufficient, the SEC explicitly expects an adviser “to eliminate the conflict or
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adequately mitigate the conflict so that it can be more readily disclosed. The SEC’s interpretation in the Investment Advisers Release thus suggests that, with its emphasis on the understandability of disclosure, investment advisers may be required to develop separate tiers of clients based on each client’s relative sophistication and ability to understand the investment adviser’s disclosed conflicts of interest.

The SEC states that it is hopeful that, in issuing its interpretation, it “causes some investment advisers to properly identify circumstances in which disclosure alone cannot cure a conflict of interest…[and] lead those investment advisers to take additional steps to mitigate or eliminate the conflict.”

C. OTHER ISSUES

In 2011, the SEC issued the 913 Study, which included the recommendation, among others, that the SEC consider harmonizing certain regulatory requirements of broker-dealers and investment advisers where such harmonization appears likely to enhance meaningful investor protection. In response to this recommendation the SEC has identified certain areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context. The SEC has requested comments on the following three identified areas:

- whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers;
- whether the SEC should propose rules to require registered investment advisers to provide clients with account statements; and
- whether SEC-registered investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers.

III. FORM CRS – CUSTOMER RELATIONSHIP SUMMARY

In its release titled “Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles” (Release No. 34-83063; IA-4888; File No. S7-08-18) (the “Relationship Summary Release”), the SEC expressed concern that retail investors are confused about the differences among registered investment advisers, registered broker-dealers, and dual-registrants (referred to together as “firms”), and the scope, nature and cost of the services they each provide. The SEC has sought to address this concern by proposing a package of new and amended rules and forms under both the Advisers Act and the Exchange Act that:

- require registered broker-dealers and registered investment advisers to provide a Form CRS to retail investors;
- restrict broker-dealers and associated natural persons of broker-dealers from using the term “adviser” or “advisor” when communicating with a retail investor; and
- require firms and their associated natural persons and supervised persons, respectively, to disclose the firm’s registration status with the SEC and an associated natural person’s and/or supervised person’s relationship with the firm in retail investor communications.

SEC Proposes Standard of Conduct for Broker-Dealers and Interpretation Regarding Standard of Conduct for Investment Advisers
May 10, 2018
A. FORM CRS

1. Overview

The SEC has proposed that registered investment advisers and registered broker-dealers be required to deliver a relationship summary in Form CRS to retail investors. Form CRS would be provided to a retail investor at the beginning of his or her relationship with a firm, and updated by the firm following any material change in the relationship, and is intended to be in addition to (and not in lieu of) current disclosure and reporting requirements or other obligations for firms.

The SEC’s stated goal in requiring firms to provide a Form CRS is to inform retail investors about the relationships and services offered by the firm, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events, all with a view to prompting retail investors to ask informed questions when engaging the firm’s services.

For the purposes of the proposed rule, “retail investors” would include all natural persons, regardless of an individual’s net worth, and thus would cover accredited investors, qualified clients or qualified purchasers. The definition would also include a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust. As noted in Section I.C.4 of this Memorandum, this definition of “retail customer” differs from the definition of “retail investor” under proposed Regulation Best Interest.

2. Content

In establishing Form CRS, the SEC has indicated that it hopes to create a tool that will facilitate comparisons across firms that offer the same or substantially similar services.66 To that end, the SEC has proposed to significantly limit the discretion of firms in drafting their relationship summary by prescribing much of the content and presentation of information to be included in the Form CRS.67 Only where a prescribed statement is not applicable to the firm’s business, or would be misleading to a reasonable retail investor, would the proposed rules permit a firm to omit or modify that prescribed statement.

The below table summarizes the items that would need to be included in Form CRS. To aid firms in understanding the disclosures required by the proposed rule, the SEC has created three mock-ups of Form CRS, one for an investment advisory firm, one for a brokerage firm and one for a dual-registrant. Hyperlinks to these mock-ups are included in Annex A to this Memorandum.68
<table>
<thead>
<tr>
<th>Item</th>
<th>Purpose</th>
<th>Information to Be Included</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>To briefly highlight the types of accounts and services the firm offers</td>
<td>• Title</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Firm name</td>
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<tr>
<td></td>
<td></td>
<td>• SEC registration status</td>
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<tr>
<td></td>
<td></td>
<td>• Date of the relationship summary</td>
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<tr>
<td></td>
<td></td>
<td>• A brief explanation of the types of accounts and services the firm offers</td>
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<td></td>
<td></td>
<td>• SEC-prescribed wording about the nature of the firm (varies depending on whether the firm is a broker-dealer, investment adviser or both)</td>
</tr>
<tr>
<td>Relationships and Services</td>
<td>To provide information about the relationships between the firm and retail investors and the investment advisory account services and/or brokerage account services the firm provides</td>
<td>• A mix of SEC-prescribed wording and short narrative statements about the nature, scope, and duration of the firm’s relationships and services</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The required information varies depending on whether the firm is a broker-dealer, investment adviser or both, but generally includes information relating to:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• the types of accounts and services the firm offers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• the nature of the firm’s fees (e.g., transaction based fees)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• whether the firm significantly limits the types of investments available to retail investors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• regular communications the firm has with investors</td>
</tr>
<tr>
<td>Standard of Conduct to Retail Investors</td>
<td>To provide a brief overview of the standards of conduct to which broker-dealers and investment advisers must adhere</td>
<td>• SEC-prescribed wording that describes the standard of conduct applicable to investment advisers and/or broker-dealers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dual-registrants would be required to provide this information in tabular format to facilitate comparison</td>
</tr>
<tr>
<td>Summary of Fees and Costs</td>
<td>To provide an overview and greater clarity with respect to the specified types of fees and expenses that retail investors will pay in connection with their brokerage and investment advisory accounts</td>
<td>• SEC-prescribed wording at the beginning of the section that prompts retail investors to seek personalized information on fees and costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A description of the principal types of fees that the firm will charge and whether such fees vary and are negotiable; the description should include key factors to help an investor understand the fee they are likely to pay</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A statement that retail investors may prefer</td>
</tr>
<tr>
<td>Item</td>
<td>Purpose</td>
<td>Information to Be Included</td>
</tr>
<tr>
<td>----------------------</td>
<td>-------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td><strong>Purpose</strong></td>
<td>paying a different type of fee in certain specified circumstances</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A statement that some investments impose fees that will reduce the value of a retail investor’s investment over time with relevant examples</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Disclosure of any incentives the firm and its financial professionals have to put their own interests ahead of their retail investors’ interests based on the account fee structure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• SEC-prescribed wording about the nature of certain fees and incentives, which varies based on whether the firm is a broker-dealer, investment adviser or both</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Dual-registrants would be required to provide this information in tabular format to facilitate comparison</td>
</tr>
<tr>
<td><strong>Comparisons</strong></td>
<td>To provide a comparison of typical brokerage or investment adviser accounts to help retail investors decide whether their needs might be better met with services from another type of firm</td>
<td>• Stand-alone investment advisers and stand-alone broker-dealers would be required to prepare this item under the following headings:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “Compare with Typical Brokerage Accounts” (for stand-alone investment advisers)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “Compare with Typical Advisory Accounts” (for stand-alone broker-dealers)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Stand-alone broker-dealers would include SEC-prescribed wording and a SEC-prescribed tabular chart about a generalized retail investment adviser. Stand-alone investment advisers would provide the same for a generalized broker-dealer</td>
</tr>
<tr>
<td><strong>Conflicts of Interest</strong></td>
<td>To provide retail investors with information so they are aware of and understand conflicts of interest at or before the start of their relationship with a firm</td>
<td>• SEC-prescribed language stating that the firm benefits from providing services to the investors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A statement disclosing:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• any financial incentives the firm has to offer or recommend certain investments because (i) they are issued, sponsored or managed by the firm or its affiliates, (ii) third parties compensate the firm when it recommends or sells the investments or (iii) both, and examples of the types of investments (e.g., mutual</td>
</tr>
<tr>
<td>Item</td>
<td>Purpose</td>
<td>Information to Be Included</td>
</tr>
<tr>
<td>---------------------</td>
<td>-------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>funds and variable annuities) associated with each of these conflicts</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• any revenue sharing arrangements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• any principal trading engaged in by the firm, including that the firm can earn a profit on those trades and that the firm has an incentive to encourage the retail investor to trade with it</td>
</tr>
<tr>
<td>Additional</td>
<td>To help retail investors be better informed when they choose a firm and a financial professional, including by providing information on disciplinary history</td>
<td>• SEC-prescribed language encouraging investors to seek additional information, directing investors to a disciplinary history of the firm, and providing details of how to report complaints and problems</td>
</tr>
<tr>
<td>Information</td>
<td></td>
<td>• Information on whether the firm is required to disclose legal or disciplinary events to the SEC, self-regulatory organizations, state securities regulators or other jurisdictions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• If legal or disciplinary events have been reported, inclusion of an affirmative statement that the firm and its financial professionals have reportable legal or disciplinary events</td>
</tr>
<tr>
<td>Key Questions</td>
<td>To encourage retail investors to have conversations with their financial professionals about how the firm’s services, fees, conflicts and disciplinary events affect them</td>
<td>• A list of ten SEC-prescribed questions under the heading “Key Questions to Ask”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Firms must use formatting to make the questions noticeable and prominent</td>
</tr>
</tbody>
</table>

### 3. Filing Obligations

Under the proposed rule, firms would be required to electronically file Form CRS and any updates with the SEC. Such filings would therefore be subject to Section 207 of the Advisers Act and Section 18 of the Exchange Act, which make it unlawful to willfully make an untrue statement of material fact, or willfully omit to state any material fact required to be stated, in the Form CRS.
Firms would have the following filing obligations with respect to Form CRS:

<table>
<thead>
<tr>
<th>Filing Obligations for Form CRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Adviser</strong></td>
</tr>
<tr>
<td><strong>Broker-dealer</strong></td>
</tr>
<tr>
<td><strong>Dual-registrant</strong></td>
</tr>
</tbody>
</table>

4. **Delivery Obligations**

The proposed rule would require firms to deliver a Form CRS to each retail investor before or at the time the retail investor engages the firm’s services. Specifically, firms would have the following delivery obligations with respect to Form CRS:

<table>
<thead>
<tr>
<th>Delivery Obligations for Form CRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Adviser</strong></td>
</tr>
<tr>
<td><strong>Broker-dealer</strong></td>
</tr>
<tr>
<td><strong>Dual-registrant</strong></td>
</tr>
</tbody>
</table>

Electronic delivery of Form CRS would be permitted. The proposed rule would also require firms to maintain a public website on which the Form CRS would be made readily accessible for retail investors.

5. **Updating Requirements**

A firm would be required to provide a Form CRS to an existing client or customer who is a retail investor before or at the time a new account is opened or whenever changes are made to the retail investor’s account(s) that would materially change the nature and scope of the firm’s relationship with the retail investor. Further, a firm would be required to update its Form CRS within 30 days whenever any information contained therein becomes materially inaccurate.

6. **Compliance Timetable**

In order to provide adequate notice and opportunity for firms to comply with the proposed Form CRS filing obligations, the SEC would require compliance on the following timetable:

-30-

SEC Proposes Standard of Conduct for Broker-Dealers and Interpretation Regarding Standard of Conduct for Investment Advisers
May 10, 2018
Proposed Compliance Dates for Form CRS

| Newly Registered Broker-dealers and New Applicants for Registration as Investment Advisers | (i) Electronically file or deliver Form CRS by the date six months after the effective date of the proposed new rules and amendments; or  
(ii) After that date, newly registered broker-dealers would be required to file their Form CRS by the date on which their registration becomes effective, and applicants for registration as an investment adviser would need to include in their applications a relationship summary that satisfies the requirements of Form ADV, Part 3: Form CRS. |
| Registered Investment Advisers and Broker-dealers (as of the effective date of the proposed new rules and amendments) | (i) Electronically file or deliver Form CRS as part of the firm’s next annual updating amendment to Form ADV that is required by the date six months after the effective date of the proposed new rules and amendments; and  
(ii) Deliver Form CRS to all existing clients who are retail investors on an initial one-time basis within 30 days after the date the firm is first required to file its Form CRS with the SEC. |

7. Recordkeeping Requirements

The SEC is also proposing amendments to Advisers Act rule 204-2 and Exchange Act rules 17a-3 and 17a-4, which set forth requirements for maintaining, making and preserving specified books and records. As applied to Form CRS, the proposed changes would require firms to retain copies of each Form CRS and any updates, as well as a record of dates each relationship summary and each update was provided to a client or prospective client that subsequently becomes a client. These records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a) of the Advisers Act, and the records for broker-dealers would be required to be maintained for a period of six years. Like other records, Form CRS and any updates would be required to be provided by a firm to the SEC staff promptly upon request.

B. RESTRICTIONS ON THE USE OF CERTAIN NAMES AND TITLES AND REQUIRED DISCLOSURES

According to the Relationship Summary Release, the SEC believes, based on the conclusions of multiple studies, that certain names or titles used by broker-dealers, including “financial advisor,” has contributed to confusion among retail investors as to the distinction among different firms and investment professionals, including the different regulatory regimes and business models under which they give advice. In particular, the SEC is of the view that some broker-dealers use certain names and titles in order to obscure the type of services they provide and mislead retail investors into believing that they are engaging with an investment adviser who is subject to an adviser’s fiduciary duties.
While the SEC believes that Form CRS will help ameliorate some of this confusion, it remains concerned that the relationship summary is not a complete remedy. In order to deter potentially misleading sales practices, the SEC has proposed to restrict certain persons from using the term “adviser” or “advisor” and require firms to disclose their regulatory status in retail investor communications.

Specifically, the proposed rule would restrict any broker or dealer, and any natural person who is an associated person of such broker or dealer, from using as part of its name or title the words “adviser” or “advisor” when communicating with a retail investor, unless (i) such broker or dealer is registered as an investment adviser under the Advisers Act or with a state, or (ii) any natural person who is an associated person of such broker or dealer is a supervised person of an investment adviser registered under Section 203 of the Advisers Act or with a state and such person provides investment advice to the retail investor on behalf of such investment adviser.

The proposed rule would permit firms that are dually registered as both an investment adviser (including state-registered investment advisers) and a broker-dealer to use the term “adviser” or “advisor” in their name or title. At the firm level, the SEC does not believe that the determination of when the restriction applies should be based on what capacity a dually registered firm is acting in a particular circumstance. Similarly, dual-hatted financial professionals of dually registered firms that provide services as an investment adviser to retail investors are permitted to use names or titles which include “adviser” and “advisor,” even if, as a part of their business, they also provide brokerage services. In contrast, financial professionals of dually registered firms that only provide brokerage services will be restricted from using the title “adviser” or “advisor” despite such person’s association with a dually registered firm.

In its release, the SEC goes to some length to note that its proposed restriction on the use of “adviser” and “advisor” in names and titles in combination with the requirement to deliver a Form CRS is, compared to alternatives it considered, the most simple and administrable approach to address the confusion about the difference between investment advisers and broker-dealers.

C. DISCLOSURES ABOUT A FIRM’S REGULATORY STATUS AND A FINANCIAL PROFESSIONAL’S ASSOCIATION

The proposed rules in the Relationship Summary Release would require prominent disclosure by firms and financial professionals of their regulatory status in all print or electronic retail investor communications, including on business cards and televised or video presentations, as summarized in the table below.
Example Disclosure of Regulatory Status by Firms and Financial Professionals

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Advisers registered under Section 203 of Investment Advisers Act</strong></td>
<td>“[Name of Firm], an SEC-registered investment adviser.”</td>
</tr>
<tr>
<td><strong>Broker-dealers</strong></td>
<td>“[Name of Firm], an SEC-registered broker-dealer.”</td>
</tr>
<tr>
<td><strong>Dual-registrants</strong></td>
<td>“[Name of Firm], an SEC-registered broker-dealer and SEC-registered investment adviser.”</td>
</tr>
<tr>
<td><strong>Associated natural persons of a broker-dealer</strong></td>
<td>“[Name of professional], a [title] of [Name of Firm], an associated person of an SEC-registered broker-dealer.”</td>
</tr>
<tr>
<td><strong>A supervised person of an investment adviser</strong></td>
<td>“[Name of professional], a [title] of [Name of Firm], a supervised person of an SEC-registered investment adviser.”</td>
</tr>
<tr>
<td><strong>A person who is both an associated person of a broker-dealer and a supervised person of an investment adviser</strong></td>
<td>“[Name of professional], a [title] of [Name of Firm], an associated person of an SEC-registered broker-dealer and a supervised person of an SEC-registered investment adviser.”</td>
</tr>
</tbody>
</table>

Disclosure of registration status must be displayed prominently on investor communications, in a type size at least as large as and of a font style different from, but at least as prominent as, that used in the majority of the communications.

The SEC has not provided a specific deadline for implementation, instead proposing to stage the compliance date to ensure that firms and financial professionals can phase out older communications from circulation.

* * *
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Field available exemptions to the extent applicable after the Fifth Circuit’s decision, but the Department will not treat an adviser’s failure to rely upon such other exemptions as to rely upon other av


As part of the BIC Exemption, broker-dealers would need to provide advice in the investor’s best interest; charge only reasonable compensation; and avoid misleading statements about fees and conflicts of interest (collectively, “Impartial Conduct Standards”).


See Principal Transactions Exemption; 18-Month Extension of Transition Period and Delay of Applicability Dates; Best Interest Contract Exemption (PTE 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (PTE 2016-02); Prohibited Transaction Exemption 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters (PTE 84-24), 82 FR 56545 (Nov. 29, 2017), available at https://federalregister.gov/d/2017-25760.

Chamber of Commerce of the U.S.A., et al. v. U.S. Dep’t of Labor, et al., No. 17-10238 (5th Cir.) (Mar. 15, 2018). The DOL has chosen not to file a motion for en banc review of the Court’s March 15, 2018 decision (the filing deadline was April 30, 2018). Accordingly, the only remaining avenue for appeal would be a petition for a writ of certiorari to the Supreme Court.

U.S. Department of Labor, Employee Benefits Security Administration, Temporary Enforcement Policy on Prohibited Transactions Rules Applicable to Investment Advice Fiduciaries, Field Assistance Bulletin No. 2018-02 (May 7, 2018), available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-02. The DOL went on to state that “investment advice fiduciaries may also choose to rely upon other available exemptions to the extent applicable after the Fifth Circuit’s decision, but the Department will not treat an adviser’s failure to rely upon such other exemptions as

SEC Proposes Standard of Conduct for Broker-Dealers and Interpretation Regarding Standard of Conduct for Investment Advisers
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resulting in a violation of the prohibited transaction rules if the adviser meets the terms of this enforcement policy.”


Proposed Regulation Best Interest would not include an exemption for any subset of broker-dealers, including broker-dealers that are small entities.

See proposed rule § 240.15I-1(a)(1).

Regulation Best Interest Release, at 46.

The Investment Advisers Act does not expressly include a fiduciary duty. Instead, courts and the SEC have interpreted Section 206 of the Advisers Act to impose a fiduciary standard of conduct. See, e.g., SEC v. Capital Gains, supra note 8.

Regulation Best Interest Release, at 86.

See Section 29(a) of the Exchange Act.

See, e.g., FINRA Regulatory Notice 12-25 at Q2 and Q3 (regarding the scope of “recommendation”); see also Michael F. Siegel, Exchange Act Release No. 58737, at “21-27 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings) (applying FINRA’s guiding principles to determine that a recommendation was made), aff’d in relevant part, Siegel v. SEC, 592 F.3d 147 (D.C. Cir. 2010), cert. denied, 560 U.S. 926 (2010); In re Application of Paul C. Kettler, Exchange Act Release No. 31354 at 5, n.11 (Oct. 26, 1992). Some commenters agreed that the Commission should use FINRA’s definition and guidance of recommendation in establishing a standard of conduct for broker-dealers. See AFL-CIO Letter (“Because DOL relied on FINRA guidance with regard to what constitutes a recommendation, the SEC could simply adopt that same definition for its own rulemaking purposes”); Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (Sept. 14, 2017) (“While the determination of whether a recommendation has been made will always be based on the particular facts and circumstances, FINRA guidelines provide a sound basis for such a definition.”). See also Business Conduct Standards Adopting Release.

This approach is consistent among FINRA and the DOL Fiduciary Rule.


See, e.g., FINRA Regulatory Notice 12-25 at Q3 (regarding the scope of “implicit recommendation”); see also infra Section II. F for further discussion.

Regulation Best Interest Release, at 86.

See Section III of the Memorandum. Form CRS would require a brief and general description of the types of fees and expenses that retail investors will pay, under the Disclosure Obligation broker-dealers can build upon Form CRS to provide more specific fee disclosures relevant to the recommendation to the retail customer and the particular brokerage account for which recommendations are made. In addition, while Form CRS would require a high-level description
of specified conflicts of interest, the Disclosure Obligation would require more comprehensive disclosure.

A stand-alone broker-dealer will be deemed to have reasonably disclosed the capacity in which it is acting at the time of the recommendation if the broker-dealer has already delivered to the retail customer the Form CRS and Regulatory Status Disclosure as outlined in Section III of this Memorandum. However, dual-registrants will not be considered to have reasonably disclosed the capacity in which it is acting at the time of the recommendation even if it has already delivered to the retail customer the Form CRS and Regulatory Status Disclosure, as neither disclosure would provide any greater clarity about the capacity in which the dual-registrant is acting in the context of the particular recommendation.

See, e.g., De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293 (2d Cir. 2002) ("On a transaction-by-transaction basis, the broker... is obliged to give honest and complete information when recommending a purchase or sale."); see also Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (finding duty to disclose material facts "in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent").

The SEC notes that disclosure should be concise, clear and understandable; should apply plain English principles; and should avoid legal jargon, highly technical business terms or multiple negatives. The use of graphics would be permitted.

Further, disclosures must be true and may not omit any material facts necessary to make the required disclosures not misleading. As noted, proposed Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the SEC may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. For example, any transactions or series of transactions, whether or not subject to the provisions of Regulation Best Interest, remain subject to the antifraud and anti-manipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Exchange Act [15 U.S.C. 78i, 78j(b), and 78o(c)] and the rules thereunder.

Pursuant to the fiduciary duty under Sections 206(1) and (2) of the Advisers Act, an investment adviser must eliminate, or at least disclose, all conflicts of interest. However, as this duty is derived from the antifraud provisions, strict liability does not apply. In particular, scienter is required to establish violations of Section 206(1) of the Advisers Act, but a showing of negligence is adequate (i.e., scienter is not required) to establish a violation of Section 206(2). The DOL Fiduciary Rule also avoids strict liability through the “good faith” exemption in its BIC Exemption.

The BIC Exemption’s “best interest” Impartial Conduct Standard would require that advice be in a retirement investor’s best interest of a retirement investor, and further defines advice to be in the “best interest” if the person providing the advice acts “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with the such matters would use...without regard to the financial or other interests” of the person. BIC Exemption Release, 81 FR at 21007, 21027; BIC Exemption Section II(c)(1); Section VIII(d).

See FINRA Rule 2111.05 (Suitability).

In the Regulation Best Interest Release, the SEC notes that the term "prudence" is not a term frequently used in the federal securities laws; however, the SEC believes that this term conveys the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care.

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See SEC v. Capital Gains, supra note 8 (describing advisers’ “basic function” as “furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments”).

See Investment Advisers Act Release No. 3060, supra note 44; see also 913 Study, supra note 11.

Investment Advisers Release, at 15.

See Investment Advisers Act Release No. 3060, supra note 44 (stating that “as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship”). See also General Instruction 3 to Part 2 of Form ADV (“Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship.”) (emphasis in original).

See SEC v. Capital Gains, supra note 8 (citing ethical standards of one of the leading investment counsel associations, which provided that an investment counsel should remain “as free as humanly possible from the subtle influence of prejudice, conscious or unconscious” and “avoid any affiliation, or any act which subjects his position to challenge in this respect”).

Investment Advisers Release, at 18.

ld., at 19.

ld., at 23.


Relationship Summary Release, at 16.

The proposed rule requires firms to use “plain language” in their Form CRS and explicitly prohibits the use of legal jargon, highly technical business terms or multiple negatives. Further, a strict four-page limit (or equivalent limit if in electronic form) would be mandated with firms prohibited from including any information other than what the instructions and the applicable item require or permit. The SEC is encouraging the use of methods such as embedded hyperlinks to direct retail investors to additional disclosures. Relationship Summary Release, at 18-19, 21.

The SEC notes that these mock-ups do not provide a safe harbor and, depending on the circumstances of a particular firm, a Form CRS that merely copies the mock-ups may not provide
sufficient or accurate information about the firm, including for purposes of meeting the firm’s obligations under the antifraud provisions of the federal securities laws. Relationship Summary Release, at 17.

Advisers Act proposed rule 204-2(a)(14)(i); Exchange Act proposed rules 17a-3(a)(24) and 17a-4(e)(10).

See Advisers Act rule 204-2(e)(1); and Exchange Act rule 17a-4(e)(10). Pursuant to Advisers Act rule 204-2(e)(1), investment advisers will be required to maintain the relationship summary for a period of five years, while Exchange Act proposed rule 17a-4(e)(10) would require broker-dealers to maintain the relationship summary for a period of six years.

See Advisers Act rule 204-2(g)(2); and Exchange Act rule 17a-4(j).

Siegel & Gale Study, supra note 65; RAND Study, supra note 65.

Relationship Summary Release, at 163.

Id., at 182.
SULLIVAN & CROMWELL LLP

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Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

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Annex A: Hypothetical Relationship Summaries Prepared by SEC Staff

The SEC has prepared three sample Relationship Summaries:

- Form CRS for broker-dealers
- Form CRS for investment advisers
- Form CRS dual-registrants
SEC Proposes ETF Rule, Amends Liquidity Risk Reporting Rule and Requires Inline XBRL Reporting by Funds

SUMMARY
At an open meeting held on June 28, 2018, the Securities and Exchange Commission (SEC) voted, among other actions, to: (i) propose a rule and related form amendments under the Investment Company Act of 1940 that would permit exchange-traded funds that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC; (ii) adopt amendments to Form N-PORT and Form N-1A related to liquidity risk management by open-end management investment companies (other than money market funds and small business investment companies); and (iii) adopt amendments to rules and forms to require the use of the Inline eXtensible Business Reporting Language (XBRL) format for submission of fund risk and return summary information.

New Exemptive Rule for Most Exchange-Traded Funds: The SEC voted unanimously to propose for comment a new rule and form amendments intended to modernize the regulatory framework for most exchange-traded funds (ETFs). Under the proposed rule, ETFs that satisfy certain conditions would be permitted to operate within the scope of the Investment Company Act of 1940 (the Investment Company Act) and participate in the market without applying for individual exemptive orders from the SEC. ETFs relying on the rule would need to comply with conditions that are generally consistent with the conditions in existing exemptive orders. The SEC is also proposing to “replace hundreds of individualized exemptive orders with a single rule,” and rescind exemptive relief previously granted to an ETF if the ETF would be able to rely on proposed rule 6c-11 in order to “level the playing field among most ETFs and protect ETF
The SEC is seeking comment from the public on various aspects of the proposal; comments are due 60 days after publication of the proposal in the Federal Register.

**Changes to Liquidity Risk Management Reporting Requirements for Certain Open-End Funds:** The SEC voted 3-2 (Commissioners Stein and Jackson dissenting) to adopt rule and form amendments that would require certain funds to discuss in their annual or semiannual shareholder reports the operation and effectiveness of their liquidity risk management programs, which replaces a currently pending requirement that funds publicly disclose historical aggregate liquidity classification data for their portfolios through Form N-PORT. The SEC also adopted amendments that will permit a fund to attribute a percentage amount of a single portfolio holding into multiple liquidity categories in specified circumstances. The amendments will become effective on September 10, 2018.

**Inline XBRL Requirements:** The SEC voted 4-1 (Commissioner Pierce dissenting) to adopt amendments that would require the use of Inline XBRL for risk/return summaries submitted to the SEC by funds. The SEC also eliminated the requirement to post XBRL data on websites. The amendments will take effect in phases.

This memorandum summarizes key aspects of the SEC’s package of approved and proposed rules. The discussion of Inline XBRL is limited to the principal aspects relevant to registered investment companies. For a discussion of the new Inline XBRL requirements for operating companies, please see our memorandum dated July 5, 2018, “SEC Adopts New Rules Affecting Public Company Reporting.”

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I. NEW APPROVAL PROCESS FOR MOST EXCHANGE-TRADED FUNDS

In its release titled “Exchange Traded Funds” (Release No. IC-33140; File No. S7-15-18), the SEC voted to propose a new rule under the Investment Company Act with the stated goal of “creat[ing] a consistent, transparent, and efficient regulatory framework for ETFs” and “facilitat[ing] greater competition and innovation among ETFs.” Under the proposed set of rules and form amendments, ETFs that satisfy certain conditions would be permitted to operate without obtaining an exemptive order from the SEC under the Investment Company Act. The specific proposals are as follows:

- **Proposed Rule 6c-11:** the new rule would create a consistent regulatory framework for ETFs by eliminating certain conditions that the SEC has previously included within its numerous individualized exemptive orders and by removing historical distinctions between actively managed and index-based ETFs.

- **Rescission of Certain ETF Exemptive Relief:** the SEC is proposing to (i) rescind exemptive relief previously granted to an ETF if the ETF would be able to rely on proposed rule 6c-11; (ii) rescind exemptive relief permitting ETFs to operate in a master-feeder structure; and (iii) grandfather existing master-feeder arrangements involving ETF feeder funds while preventing the formation of new ones.

- **Proposed Amendments to Forms N-1A and N-8B-2:** the proposed amendments would require ETFs to provide additional information on Form N-1A (the form for open-end management investment companies) and Form N-8B-2 (the form for unit investment trusts) to investors who purchase and sell ETF shares in the secondary markets, such as the bid-ask spread, and premiums and discounts from the ETF’s net asset value (NAV); the requirement would apply equally to ETFs structured as registered open-end management investment companies or unit investment trusts.

A. BACKGROUND

The SEC first granted relief to permit an ETF to operate in 1992; today, there are more than 1,900 SEC-registered ETFs with aggregate net assets of $3.4 trillion, approximately 15% of total net assets of all registered investment companies. ETFs have characteristics of both mutual funds, which issue redeemable securities, and closed-end funds, which generally issue shares that are not redeemable and that are listed on a national securities exchange and trade at market-determined prices. The creation and redemption processes of an ETF together with secondary market trading in ETF shares provide arbitrage opportunities designed to maintain the market price of ETF shares at or close to the NAV per share of the ETF.

ETFs currently operate as investment companies under the Investment Company Act in reliance on exemptions from certain provisions thereof, with the SEC having granted over 300 exemptive orders to date. The SEC first proposed rule 6c-11 under the Investment Company Act in 2008 to permit ETFs to
B. PROPOSED RULE 6c-11

1. Scope

Proposed rule 6c-11 would define an ETF as a registered open-end management investment company that (i) issues and redeems creation units to and from authorized participants in exchange for a basket of “securities, assets or other positions” and cash balancing amount, if any; and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices.5

The proposed rule would apply only to certain types of ETFs:

<table>
<thead>
<tr>
<th>Type of ETF</th>
<th>Within Scope of Proposed Rule 6c-11?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ETFs organized as Open-End Management Investment Companies</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>ETFs organized as Unit Investment Trusts</strong></td>
<td>No, but existing UIT ETFs will be grandfathered</td>
</tr>
<tr>
<td><strong>Index-Based ETFs</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Actively Managed ETFs</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Leveraged ETFs</strong></td>
<td>No. New leveraged ETFs may apply for an exemptive order</td>
</tr>
<tr>
<td><strong>Share Class ETFs</strong></td>
<td>No. New share class ETFs may apply for an exemptive order</td>
</tr>
<tr>
<td><strong>Master-Feeder ETFs</strong></td>
<td>No, but existing master-feeder ETFs will be grandfathered</td>
</tr>
</tbody>
</table>

a. Open-End Management Investment Companies

The proposed rule would apply only to ETFs organized as open-end management investment companies, and would not apply to those organized as UITs “given the limited sponsor interest in developing ETFs organized as UITs” and the different regulatory framework required by the unmanaged nature of UITs.6 The SEC notes that most ETFs today are open-end management investment companies rather than UITs. ETFs organized as UITs would continue to operate under the terms and conditions in their exemptive orders.

b. Index-Based ETFs and Actively Managed ETFs

Proposed rule 6c-11 would provide exemptions for both index-based ETFs and actively managed ETFs, which the SEC considers to be similar in respect of operational matters despite their different investment
objectives or strategies. The SEC believes that permitting index-based and actively managed ETFs to operate under the same rule would "provide a level playing field among those market participants," and would provide a more consistent and transparent regulatory framework.

c. Leveraged ETFs

The proposed rule would not be available for leveraged ETFs, identified in the proposed rule as those that "seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time" and that typically require a rebalancing of their portfolios on a daily basis. The SEC states that this daily reset feature and the effects of compounding leveraged returns may result in performance significantly different from some investors’ expectations.

d. Share Class ETFs

Proposed rule 6c-11 would not cover an ETF "structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio." Hence, the proposed rule would not provide any relief from sections 18(f)(1) or 18(i) of the Investment Company Act, nor would it expand the scope of rule 18f-3 under the Investment Company Act, which provides a limited exemption from sections 18(f)(1) and 18(i) by permitting registered open-end management investment companies or series or classes thereof to issue more than one class of voting stock.

ETFs seeking relief from sections 18(f)(1) or 18(i) are expected to do so through the SEC’s exemptive application process, where the SEC can continue to weigh policy considerations in the context of the facts and circumstances of a particular applicant.

e. Master-Feeder ETFs

Although the SEC’s exemptive orders have previously provided relief allowing ETFs to operate as feeder funds in a master-feeder structure, due to the lack of interest in this structure the SEC is proposing to rescind the master-feeder relief granted to ETFs that do not in fact rely on the relief as of the date of the proposal (June 28, 2018). The SEC proposes to grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones by amending relevant exemptive orders.

2. Exemptive Relief Under Proposed Rule 6c-11

Consistent with prior exemptive orders, proposed rule 6c-11 would provide exemptions to ETFs within its scope from certain provisions of the Investment Company Act. Specifically, the rule would permit an ETF meeting the conditions of the proposed rule to:

- redeem shares only in creation unit aggregations;
issue shares to be purchased and sold at market prices rather than at NAV per share;
engage in in-kind transactions with certain affiliates; and
in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.

a. Treatment of ETF Shares as “Redeemable Securities”

Under the proposed rule, an ETF would be considered to issue “redeemable securities” within the meaning of section 2(a)(32) of the Investment Company Act and regulated as an open-end fund within the meaning of section 5(a)(1) of the Investment Company Act. Therefore, the rules under the Securities Exchange Act of 1934 (the Exchange Act) that apply to redeemable securities would apply to ETFs relying on proposed rule 6c-11. Consequently, ETFs relying on the proposed rule would be eligible for (i) the “redeemable securities” exceptions under rules 101(c)(4) and 102(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units, and (ii) the exemption for a “registered open-end investment company” in rule 11d1-2 under the Exchange Act.

b. Trading of ETF Shares at Market-Determined Prices

Section 22(d) of the Investment Company Act prohibits investment companies from selling a redeemable security to the public at a price different from the current public offering price in the prospectus. Rule 22c-1 requires dealers to sell, redeem, or repurchase a redeemable security only at a price based on its NAV.

Consistent with prior exemptive orders, proposed rule 6c-11 would provide exemptions from section 22(d) and rule 22c-1 to allow investors to purchase and sell individual ETF shares on the secondary market at market-determined prices that may be different from the price in the prospectus or based on NAV. The SEC believes exemptions from these provisions are appropriate because the arbitrage mechanism already addresses the concerns of shareholder dilution and unjust discrimination behind these provisions.

c. Affiliated Transactions

Section 17(a) of the Investment Company Act prohibits purchases and redemptions of ETF creation units by affiliated persons of ETFs.

Consistent with prior exemptive orders, the proposed rule would provide an exemption from sections 17(a)(1) and 17(a)(2) of the Investment Company Act with regard to the deposit and receipt of baskets to affiliated persons of an ETF “solely by reason of: (i) holding with the power to vote 5% or more of an ETF’s shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF.”
This relief is intended promote the arbitrage mechanism and reduce concentration risk by allowing a greater pool of market participants to engage in arbitrage using in-kind baskets. However, in light of the fact that proposed rule 6c-11 would provide additional flexibility by allowing an ETF to use custom baskets (see infra Section I.B.3.e), thereby increasing the possibility of different treatments for affiliates and non-affiliates in terms of an ETF’s receipt and delivery of baskets, the SEC is not proposing to cover additional types of affiliated relationships, such as broker-dealers affiliated with an ETF.\footnote{17}

\textbf{d. Additional Time for Delivering Redemption Proceeds}

Section 22(e) of the Investment Company Act prohibits open-end funds from paying redemption proceeds more than seven days after the tender of their shares for redemption.

Proposed rule 6c-11 would grant relief from section 22(e) to permit an ETF to delay satisfaction of a redemption request if “a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents timely delivery of the foreign investment included in the ETF’s basket.”\footnote{18} An ETF relying on the exemption would need to deliver foreign investments as soon as practicable, but not later than 15 days after the tender to the ETF of one or more creation units of its shares for redemption.

The SEC is proposing to include a sunset provision in the rule, so that it would expire ten years from the rule’s effective date, owing to technological innovation and changes in market infrastructures and operations that are expected to lead to shorter settlement cycles.

\textbf{3. Conditions for Reliance on Proposed Rule 6c-11}

ETFs would be required to comply with various specified conditions in order to rely on the exemptive relief provided by proposed rule 6c-11. These conditions are generally consistent with those in prior exemptive orders, which the SEC believes have “effectively accommodated the unique structural and operational features of ETFs while maintaining appropriate protections for ETF investors.”\footnote{19}

\textbf{a. Issuance and Redemption of Shares}

Consistent with prior exemptive orders, proposed rule 6c-11 would require ETFs to “issue (and redeem) creation units to (and from) authorized participants in exchange for baskets and a cash balancing amount (if any).”\footnote{20} The SEC intends for this condition to promote the ETF share issuance and redemption process that is important for the arbitrage mechanism.

- Authorized Participant. Proposed rule 6c-11 would define an “authorized participant” as “a member or participant of a clearing agency registered with the [SEC], which has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units.”\footnote{21}
**Creation Units.** Proposed rule 6c-11 would define “creation unit” as “a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any).” 22 Under the proposed rule, an ETF would generally issue and redeem shares only in creation unit aggregations, but would be permitted to sell or redeem individual shares in limited circumstances, such as on the day of consummation of a reorganization, merger, conversion or liquidation.

**Suspension of Issuance and Redemption.** Proposed rule 6c-11 would allow an ETF to suspend “the redemption of creation units only in accordance with section 22(e) of the Investment Company Act, and an ETF may charge transaction fees on creation unit redemptions only in accordance with rule 22c-2.” 23 The SEC believes that an ETF may suspend the issuance of creation units “only for a limited time and only due to extraordinary circumstances,” such as market closures, and that it should not be able to set transaction fees so high as to effectively suspend the issuance of creation units. 24

b. **Listing on a National Securities Exchange**

Consistent with prior exemptive orders, proposed rule 6c-11 would only cover ETFs that issue shares “listed on a national securities exchange and traded at market-determined prices.” 25 Listing shares for trading on a national securities exchange is a fundamental characteristic of ETFs. This definition excludes an ETF that is suspended or delisted from a national securities exchange.

c. **Intraday Indicative Value**

Departing from exchange listing standards and prior exemptive orders, proposed rule 6c-11 would not require the dissemination of an ETF’s intraday estimate of its NAV per share, or intraday indicative value (IIV). 26 The SEC believes that the IIV is no longer used by market participants when conducting arbitrage trading, and may not represent the actual value of an ETF if its securities are traded less frequently. Proposed rule 6c-11 would instead condition its relief on the daily disclosure of portfolio holdings.

d. **Daily Portfolio Transparency**

The SEC believes that daily portfolio transparency is important for the arbitrage mechanism of ETFs. The SEC’s prior exemptive orders have generally required ETFs to provide either full or partial portfolio transparency, yet the SEC observes in the release that as a practical matter all ETFs provide full portfolio transparency. 27

**Website Disclosure.** Proposed rule 6c-11 would require an ETF to “disclose prominently on its website … the portfolio holdings that will form the basis for each calculation of NAV per share” to be made “each business day before the opening of regular trading on the primary listing exchange of the ETF’s shares and before the ETF starts accepting orders for the purchase or redemption of creation units.” 28 Departing from the 2008 proposal, the SEC is proposing a full transparency requirement for all ETFs without distinguishing between index-based ETFs or actively managed ETFs.
Disclosure of Securities, Assets or Other Investment Positions. Proposed rule 6c-11 would require an ETF to disclose on its website all portfolio holdings forming the basis of the ETF’s next calculation of NAV per share, intended to cover an ETF’s securities, assets or other positions including its cash holdings, short positions and written options. To standardize disclosure, the proposed rule would require that “portfolio holdings information be presented and contain information regarding description, amount, value and/or unrealized gain/loss (as applicable) in the manner prescribed within Article 12 of Regulation S-X, which sets forth the form and content of fund financial statements.”

e. Baskets

Proposed rule 6c-11 would require ETFs within its scope to “adopt and implement written policies and procedures” that cover the methodology used to construct and accept baskets. The rule would also give ETFs flexibility to use custom baskets if they adopt further policies and procedures that provide detailed parameters for such baskets.

Basket Flexibility. Exemptive orders since approximately 2006 have required that an ETF’s basket generally correspond pro rata to its portfolio holdings with limited exceptions. However, proposed rule 6c-11 would provide additional basket flexibility and apply the same standards to all ETFs relying on the rule. Moreover, in light of the increased risks presented by custom baskets, proposed rule 6c-11 would require an ETF using custom baskets to (i) adopt policies and procedures that are in the best interest of the ETF and its shareholders, including any processes for revisions to, or deviation from, those parameters, and (ii) specify the titles or roles of the employees of the ETF’s investment adviser that reviews such baskets for compliance purposes. The SEC believes that the ETF’s board of directors’ oversight of the ETF’s compliance policies and procedures, as well as its general oversight of the ETF, would provide an additional layer of protection.

Posting of a Published Basket. Proposed rule 6c-11 would require an ETF to prominently disclose on its website at the beginning of each business day information relating to a published basket and estimated cash balancing amount. Specifically, an ETF would need to publish one basket that it would exchange for orders to purchase or redeem creation units to be priced based on the ETF’s next calculation of NAV per share each business day.

f. Website Disclosure

Proposed rule 6c-11 would require an ETF to disclose on its website the following information:

- the ETF’s daily NAV, market price, and premium or discount, each as of the end of the prior business day;
- the median bid-ask spread for the ETF’s most recent fiscal year (this information would also be required to be disclosed in its prospectus); and
- historical information regarding the ETF’s premiums and discounts if over 2% for more than seven consecutive trading days, and a discussion of the factors reasonably believed to have contributed to the premium or discount.
Proposed rule 6c-11 would not contain the marketing requirements that have been a condition of ETF exemptive orders; for example, there will be no requirement that an ETF identify itself in sales literature as an ETF that does not sell or redeem individual shares, or that the ETF explain that investors may purchase or sell individual ETF shares through a broker via a national securities exchange.\textsuperscript{39}

4. Recordkeeping

Proposed rule 6c-11 would expressly require an ETF relying on the rule to preserve and maintain copies of all written agreements between the ETF (or its relevant service provider(s)) and authorized participants permitted to purchase or redeem creation units directly from the ETF, as well as any information regarding the baskets exchanged with authorized participants for at least five years (the first two years in an easily accessible place).\textsuperscript{40}

C. EFFECT ON PRIOR EXEMPTIVE ORDERS

The SEC is proposing to amend and rescind exemptive orders previously issued to ETFs that would be permitted to rely on proposed rule 6c-11. The SEC is proposing to rescind only the “portions of an ETF’s exemptive order that grant relief related to the formation and operation of an ETF” and would not rescind relief from section 12(d)(1) or sections 17(a)(1) and (a)(2) under the Investment Company Act related to fund of funds arrangements involving ETFs.\textsuperscript{41} The SEC further would not rescind any exemptive relief of ETFs that would not be permitted to rely on proposed rule 6c-11. In order to provide time for ETFs to transition to the new rule, the SEC is proposing to amend existing orders to provide that the relief contained therein would terminate one year following the effective date of any final rule.

D. AMENDMENTS TO FORM N-1A, FORM N-8B-2, AND FORM N-CEN

The SEC is proposing various revisions to Form N-1A, Form N-8B-2, and Form N-CEN to reflect proposed rule 6c-11.

II. AMENDMENTS TO LIQUIDITY DISCLOSURE REQUIREMENTS

In its release titled “Investment Company Liquidity Disclosure” (Release No. IC-33142; File No. S7-04-18), the SEC adopted amendments under the Investment Company Act relating to liquidity risk reporting requirements for registered open-end management investment companies and ETFs (regardless of whether they are organized as management investment companies or UITs), but excluding money market funds and small business investment companies (hereinafter, a “fund”), through Form N-PORT and Form N1-A.
A. BACKGROUND

In October 2016, the SEC adopted rule 22e-4 and new Form N-PORT under the Investment Company Act. Rule 22e-4 requires a fund to adopt a written liquidity risk management program “reasonably designed to assess and manage the fund’s liquidity risk,” and the program must classify each of the fund’s portfolio investments into one of four investment categories: (i) highly liquid, (ii) moderately liquid, (iii) less liquid, or (iv) illiquid. The rule further requires: a highly liquid investment minimum; restrictions on the amount of illiquid investments a fund may purchase; review and oversight of the liquidity risk management program by the fund’s board of directors; and recordkeeping. Funds are required to file a monthly portfolio report with the SEC on a confidential basis through Form N-PORT to disclose the liquidity categorization of each of the fund’s portfolio investments, indicating the aggregate percentage of a fund’s portfolio in each category. Information reported for the third month of each fiscal quarter on Form N-PORT would be made publicly available 60 days after the end of the fiscal quarter.

B. OVERVIEW OF CHANGES TO FORM N-PORT

The following chart summarizes the changes that have been made to the liquidity risk management disclosure framework:

<table>
<thead>
<tr>
<th>2016 Rules</th>
<th>New Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Through Form N-PORT, a fund must publicly disclose on a quarterly basis the aggregate percentages of a fund’s investment portfolios assigned to each of the four liquidity categories pursuant to rule 22e-4.</td>
<td>On the fund’s annual shareholder report, a fund must provide on an annual or semiannual basis a narrative discussion of the operation of the fund’s liquidity risk management program for the most recent fiscal year.</td>
</tr>
<tr>
<td>On Form N-PORT, a fund must disclose a single liquidity classification for each investment portfolio holding.</td>
<td>On Form N-PORT, a fund may report a single portfolio holding in multiple liquidity classifications in three specified circumstances where splitting would provide more accurate disclosure.</td>
</tr>
<tr>
<td>Cash holdings are not reported.</td>
<td>On Form N-PORT, a fund must disclose the amount of cash and cash equivalents not reported in Parts C and D thereof.</td>
</tr>
</tbody>
</table>

C. ELIMINATION OF PUBLIC REPORTING OF AGGREGATE LIQUIDITY INFORMATION

The SEC amended Item B.8 of Form N-PORT to eliminate the requirement that funds publicly disclose the aggregate percentage of its investments assigned to each liquidity category.

The SEC indicated that using aggregate liquidity information without a full explanation of the “underlying subjectivity, model risk, methodological decisions, and assumptions that shape this information” could be misleading to investors. The SEC further expressed concern that this could create incentives for funds to “classify investments as more liquid and … inappropriately highlight liquidity risk compared to other, potentially more salient risks of the fund.” At the same time, the SEC rejected amending Form N-PORT...
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to require the significant level of detail and narrative context that the SEC believes would be necessary for investors to more fully appreciate a fund’s liquidity risk profile and the subjective nature of its categorization, as this would undermine the form’s very purpose. Instead, the SEC judged that effective disclosure would be better achieved through prospectus and shareholder report disclosure than through Form N-PORT.

D. ANNUAL OR SEMIANNUAL SHAREHOLDER REPORT DISCLOSURE

In conjunction with eliminating the requirement for public disclosure of aggregate liquidity information through Form N-PORT, the SEC amended Form N-1A to require funds to briefly discuss the operation and effectiveness of a fund’s liquidity risk management program in a new section of the fund’s annual or semi-annual shareholder report.46

Rule 22e-4(b)(2) requires a fund’s board of directors to review at least once a year a written report prepared by the person designated to administer the liquidity risk management program of the fund that “addresses the operation of the program and its adequacy and effectiveness,” including, if applicable, the operation of the highly liquid investment minimum and any material changes to the program.47 Form N-1A sets out the information that funds are required to include in their shareholder reports.

Under amended Form N-1A, only liquidity events that materially affect a fund’s performance must be disclosed in the Management Discussion of Fund Performance section (MDFP) of the shareholder report. The SEC decided to move liquidity risk disclosure outside of the MDFP “because this information does not directly relate to performance results,” and doing so “would avoid concerns about unduly focusing investors on liquidity risk and diluting the MDFP.”48 By moving this disclosure to a new section on Form N-1A that may be included in either a fund’s annual or semi-annual shareholder report (compared to the MDFP which is included only in annual reports), the SEC believes that funds can better “synchronize the required annual board review of liquidity risk management programs with the production of this discussion in the shareholder report, reducing costs and allowing funds to provide more effective disclosure.”49

The SEC is not providing an exemption from the new narrative disclosure requirement for funds that primarily hold assets that are highly liquid investments or for ETFs that create and redeem their shares on an in-kind basis.50 The SEC noted that investors stand to benefit from such disclosure, even though these funds “may face fewer, or different liquidity risks than other funds, and thus the discussion … may be proportionate or different than for other funds.”51

Under the new requirement, a fund may elect to provide the same information provided to its board of directors about the operation and effectiveness of the liquidity risk management program during the previous fiscal year. Such discussions may, but are not required to, cover:
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- the role of the classification process;
- the 15% illiquid investment limit;
- the highly liquid investment minimum;
- particular liquidity risks or challenges faced during the past fiscal year, for example, significant redemptions, or changes in the overall market liquidity of the investments held by the fund; and
- other contextual and supplemental information about the fund’s liquidity risk management process, for example, empirical data metrics such as the fund’s bid-ask spreads, portfolio turnover, or shareholder concentration issues.

E. MULTIPLE CLASSIFICATION CATEGORIES

The SEC amended Item C.7 of Form N-PORT to allow a fund to attribute a percentage amount of a single holding to multiple liquidity categories in the following specific instances:

1. if portions of a fund’s portfolio have different liquidity-affecting features that may justify treating the holding as two or more separate investments for liquidity classification purposes, taking into account a reasonable anticipation of the trade size for each portion; \(^{53}\)
2. if a fund has a numerous sub-advisers managing different portions of its portfolio who hold different views on the liquidity classification of the single holding with such multiple portions, taking into account a reasonable anticipation of the trade size for each portion; or
3. if a fund classifies its holdings based on the assumed full liquidation of the entire position.

The SEC noted that the requirement to classify each holding into a single classification category “poses difficulties for certain holdings and may not accurately reflect the liquidity of that holding, or be reflective of the liquidity management practices of the fund.” \(^{54}\) The SEC believes that permitting split-reporting under the specified circumstances will allow for a more precise view of the liquidity of these securities, especially as funds will be required to indicate which circumstance led them to split-report the classification categories. \(^{55}\) Under new Item C.7.b of Form N-PORT, a fund opting to attribute multiple categories to a holding must note which of the three specified circumstances led the fund to do so.

F. DISCLOSURE OF CASH AND CASH EQUIVALENTS NOT ELSEWHERE REPORTED ON FORM N-PORT

The SEC amended Form N-PORT to add new Item B.2.f, which requires funds to publicly disclose on a quarterly basis the amount of cash and cash equivalents held but not reported in Part C (Schedule of Portfolio Investments) and Part D (Miscellaneous Securities) of Form N-PORT. \(^{56}\) While cash would be classified as a highly liquid investment under rule 22e-4 and would have been included under the former requirement for aggregate liquidity disclosure, this new disclosure on cash and cash equivalents is intended to provide more complete information in analyzing a fund’s compliance with the highly liquid investment minimum as well as to allow monitoring of trends such as net inflows and outflows. However,
to avoid double-counting items more appropriately reported in Part C or Part D, the new requirement will only apply to cash and cash equivalents not reported in those sections.

G. COMPLIANCE DATES

The SEC provided a tiered set of compliance dates based on asset size, with compliance dates set such that funds have at least one year’s experience with operating their liquidity risk management program before providing narrative disclosure in their shareholder reports.

<table>
<thead>
<tr>
<th>Compliance Date</th>
<th>First Filing Date</th>
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<td>Jun 1, 2019</td>
<td>July 30, 2019</td>
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<td>December 1, 2019</td>
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H. TREASURY ASSET MANAGEMENT REPORT AND EVALUATION OF OTHER APPROACHES

In 2017, the U.S. Department of Treasury published the “Asset Management and Insurance Report” that recommended the SEC to embrace a “principles-based” approach to liquidity risk management rulemaking. After receiving comments both in support and against such an approach, the SEC continues to solicit feedback on the new liquidity framework and to “analyze the extent to which the liquidity classification process and data” are achieving the SEC’s goals. The SEC has requested public feedback on the following topics, among others:

- the costs and benefits of the classification requirements of rule 22e-4;
- the extent that investors and others benefit from public liquidity classification information, and potential alternative types of information that could be provided; and
- whether or not the SEC should move towards a more principles-based approach, and the principles underpinning such approach.

I. COMMISSIONER REACTIONS

At the open meeting held on June 28, 2018, the two Democratic Commissioners issued dissenting statements. Commissioner Kara M. Stein referred to the new rules as a “rollback of public disclosure” and commented that, in her view, the SEC should have first observed how the originally proposed framework, which had been unanimously approved, would have worked before eliminating the
requirement for public disclosure of basic liquidity information to investors. Commissioner Stein also expressed displeasure at the notion of possibly moving to “a more principles-based approach” that may invite greater discretion in complying with the rules. Commissioner Robert J. Jackson, Jr. also commented that the adopted rules seemed to him to be based on “the bizarre claim that investors might find information about liquidity so confusing that we serve them best by keeping the information secret,” and that the SEC’s rulemaking creates uncertainty for market participants who have already made significant investments in the liquidity classification framework.

III. INLINE EXTENSIBLE BUSINESS REPORTING LANGUAGE REQUIREMENTS FOR FUNDS

In its release titled “Inline XBRL Filing of Tagged Data” (Release No. 33-10514; File No. S7-03-17), the SEC adopted amendments to require the use of the Inline eXtensible Business Reporting Language (XBRL) format for the submission of financial statement information and fund risk/return summaries; to eliminate the 15 business day XBRL filing period for fund risk/return summaries; and to eliminate the requirement for funds to post XBRL data on their websites. The amendments also eliminated the SEC’s voluntary program for the submission of interactive financial data. The amendments do not affect the categories of filers or scope of disclosures subject to XBRL requirements.

A. BACKGROUND

XBRL requirements currently apply to funds pursuant to Form N-1A and related rules under Regulation S-T. In 2009, the SEC adopted rules requiring funds to submit risk/return summary information in XBRL format as exhibits to registration statements and prospectuses, and to publish the same Interactive Data File (IDF) on their website.

On March 1, 2017, the SEC issued for comment proposals to improve the quality and usefulness of XBRL data and to decrease XBRL preparation costs in its release titled “Inline XBRL Proposing Release”.

B. FINAL AMENDMENTS

1. Inline XBRL Requirements

Under the final amendments to rule 405, funds will be required to submit risk/return summary information in XBRL format. The XBRL format allows funds to embed data directly into an HTML document, which eliminates the need to tag a copy of the information in a separate exhibit; funds must include contextual information about the XBRL tags embedded in the filing as an exhibit to the HTML document. Further, funds will remain subject to rule 405(c) which provides data quality requirements on IDF submissions.
The SEC adopted rule changes to permit funds to submit IDFs concurrently with certain post-effective amendments to registration statements and to eliminate the 15 business day filing period for the submission of risk/return summaries. The SEC extended the phase-in period in order to provide funds with additional time to transition to XBRL format and to adjust to the elimination of the filing period, as summarized in the table below.

### Related Official Filing | Timing of IDF Submission
---|---
**Post-effective amendments** filed pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of rule 485 | IDF must be filed either:
1. concurrently with the filing; or
2. in a subsequent amendment that is filed on or before the date that the post-effective amendment that contains the related information becomes effective.

**Initial registration statements and post-effective amendments** filed other than pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of rule 485 | IDF must be filed in a subsequent amendment on or before the date the registration statement or post-effective amendment that contains the related information becomes effective.

**Any form of prospectus** filed pursuant to rule 497(c) or (e) | IDF must be submitted concurrently with the filing.

The SEC expects that these amendments will allow risk/return summary information to reach investors more quickly than it currently does, as the XBRL format allows investors to view the embedded data within the context of the related official filing as an integrated, single-document without having to download the information into separate applications.

The SEC extended the phase-in period in order to provide funds with additional time to transition to XBRL format and to adjust to the elimination of the filing period, as summarized in the table below.

### Funds | Compliance Date
---|---
**Funds in groups with net assets of $1 billion or greater as of the end of the most recent fiscal year** | Any initial registration statement (or post-effective amendment that is an annual update to an effective registration statement) that becomes effective on or after **two** years after the effective date of the amendments.

**All other funds** | Any initial registration statement (or post-effective amendment that is an annual update to an effective registration statement) that becomes effective on or after **three** years after the effective date of the amendments.

The amendments permit funds to file using XBRL format prior to the applicable compliance date; funds can do so after the EDGAR system has been modified accordingly to accept such submissions, anticipated to be completed by March 2019.
2. Elimination of the Website Posting Requirements and 2005 XBRL Voluntary Program

The requirement for funds to post XBRL data on their websites will be eliminated upon the effective date of the amendments in light of the fact that users can obtain reliable access through EDGAR.\textsuperscript{76} The 2005 XBRL Voluntary Program for financial statement information interactive data will similarly be terminated as of the effective date given its very infrequent use.\textsuperscript{77}

3. Technical Amendments

The SEC adopted certain conforming changes consistent with the amendment in format to the IDF, elimination of the website posting requirements, and termination of the 2005 XBRL Voluntary Program.

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ENDNOTES

2 Id.
3 Id., at 6, 9 (explaining that ETFs have been historically organized as open-end funds or UITs under the Investment Company Act). See 15 U.S.C. §80a-5(a)(1) (defining the term “open-end company”) and 15 U.S.C. §80a-4(2) (defining the term “unit investment trust”).
4 Id., at 6.
5 Id., at 16, citing proposed rule 6c-11(a) (defining “exchange-traded fund”). Under the proposed rule, the term “basket” would be defined to mean the securities, assets, or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units. The term “exchange-traded fund” thus would include ETFs that transact on an in-kind basis, on a cash basis, or both.
6 Id., at 19. A UIT is defined as an investment company organized under a trust indenture or similar instrument that issues redeemable securities, each of which represents an undivided interest in a unit of specified securities. A UIT has a fixed life – a termination date for the trust is established upon its creation. Id., at 17.
7 Id., at 24.
8 Id., at 26.
9 Id., at 28-29.
10 Id., at 138.
11 Id., at 141.
12 Id., at 37.
13 Id., at 39.
14 Id., at 41.
15 Id., at 50 (citing 15 U.S.C. §80a-2(a)(3)(A), (B) and (C)). An affiliated person of an ETF includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of the ETF; (ii) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the ETF; and (iii) any person directly or indirectly controlling, controlled by, or under common control with the ETF.
16 Id., at 51.
17 Id., at 53.
18 Id., at 55. A “foreign investment” under proposed rule 6c-11 would be defined as “any security, asset or other position of the ETF issued by a foreign issuer (as defined by rule 3b-4 under the Exchange Act) for which there is no established U.S. public trading market (as that term is used in Regulation S-K under the Securities Act).” Id., 58-59. The relief from the requirements of section 22(e) would not affect any obligations arising under rule 15c6-1 under the Exchange Act, which requires that most securities transactions be settled within two business days of the trade date. Id., at 55 n.152 (citing 17 CFR §240.15c6-1).
19 Id., at 62.
20 Id., citing proposed rule 6c-11(a).
21 Id., at 63, citing proposed rule 6c-11(a). This definition differs from the definition of “authorized participant” recently adopted by the SEC in connection with Form N-CEN, which defines the term as a broker-dealer that is also a member of a clearing agency registered with the SEC or a Depository Trust Company participant and has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders to purchase and redeem...
creation units of the ETF. The proposed definition also differs from the definition in the SEC's prior exemptive orders and Form N-CEN as it does not include "a specific reference to an authorized participant's participation in DTC since DTC is itself a clearing agency." The SEC is proposing a corresponding amendment to Form N-CEN. Id. at 63-64.

Id., at 64, citing proposed rule 6c-11(a). While the SEC recognizes that creation unit sizes are important, it does not find it necessary to propose an express requirement that "an ETF establish creation unit sizes reasonably designed to facilitate arbitrage." Id., at 64-65.

Id., at 67.

Id., at 70, citing proposed rule 6c-11(a).

Id., at 72.

Id., at 77-80.

Id., at 77, citing proposed rule 6c-11(c)(1)(i)(A). In addition, the proposed rule would require the portfolio holdings that form the basis of the calculation to be the ETF's portfolio holdings as of the close of business on the prior business day.

Id., at 82-83.


Id., at 88.

Id. Proposed rule 6c-11 defines two types of "custom baskets" – first, baskets that are "composed of a non-representative selection of the ETF's portfolio holdings," and second, "different baskets used in transactions on the same business day." Id., at 95-96, citing proposed rule 6c-11(a).

Id., at 94.

Id., at 96-98.

Id., at 103.

Id., at 109, citing proposed rule 6c-11(c)(1)(ii). Proposed rule 6c-11 would define the term "market price" to mean: (i) the official closing price of an ETF share; or (ii) if it more accurately reflects the market price of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer, calculated as of the time NAV per share is calculated. Id. at 109-110. Further, the SEC is proposing to amend Form N-1A to remove a definition of market price that differs from the above definition. Id., at 111.

Id., at 115.

Id., at 116-20. In order to eliminate potentially duplicative disclosure requirements, the SEC is proposing to eliminate similar requirements in Item 11(g)(2) and Item 27(b)(7)(iv) of Form N-1A. Such information would need to be maintained on the website for at least one year following its posting. Id., at 118-19.

Id., at 130-31.

Id., at 134. Specifically, the proposed rule would require an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) name and quantity of the positions constituting the basket; (ii) identification of the basket as a "custom basket" and a record of its compliance with the ETF's policies; (iii) cash balancing amounts; and (iv) the identity of the authorized participant. Id.

Id., at 143.

17 CFR § 270.22e-4.

Liquidity Disclosure Release, at 12.
New Item 27(d)(7)(b) of Form N-1A.
Id., at 16.
Id.
Rule 22e-4 defines “In-Kind ETF” as an exchange-traded fund that meets redemptions through in-kind transfers of securities, positions and assets other than a de minimis amount of cash and that publishes its portfolio holdings daily. Rule 22e-4(a)(9).
Liquidity Disclosure Release, at 18.
Id., at 18-19.
The SEC lists as examples: (i) “a fund might hold an asset that includes a put option on a percentage (but not all) of the fund’s holding of the asset”; and (ii) “a fund might have purchased a portion of an equity position through a private placement that makes those shares restricted (and therefore illiquid) while also purchasing additional shares of the same security on the open market.” See Liquidity Disclosure Release at 21, fn. 77, 78.
The SEC cites the U.S. generally accepted accounting principles definition of cash equivalents: “short-term, highly liquid investment that … are … [r]eadily convertible to known amounts of cash … [and that are] [s]o near their maturity that they present insignificant risk of changes in value because of changes in interest rates.” Liquidity Disclosure Release, at 28.
The SEC defines “larger entities” as funds that, together with other investment companies in the same “group of related investment companies,” have net assets of $1 billion or more as of the end of its most recent fiscal year, and “smaller entities” as funds that, together with other investment companies in the same group of related investment companies, have net assets of less than $1 billion as of the end of its most recent fiscal year. See Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)], at n. 997.
Id.
Id.
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See General Instruction C.3.(g) to Form N-1A; rule 405 of Regulation S-T.

See Securities and Exchange Commission, Release No. 33-9006, File No. S7-12-08, Interactive Data for Mutual Fund Risk/Return Summary (Feb. 11, 2009), as corrected by Release No. 33-9006A (May 1, 2009); General Instruction C.3.(g)(i), (ii), and (iv) to Form N-1A.


See new rule 405(a)(3)(ii) of Regulation S-T.

17 CFR 232.405(c)(1).

See new General Instruction C.3.(g) to Form N-1A; see also new rule 405(a)(3)(ii) of Regulation S-T.

See new General Instruction C.3.(g)(i)(B) to Form N-1A.

See new General Instruction C.3.(g)(i)(A) to Form N-1A.

See new General Instruction C.3.(g)(ii) to Form N-1A.

Inline XBRL Filing Release, at 32.

The SEC defines “fund groups” as “groups of related investment companies” consisting of funds and other investment companies. The term “group of related investment companies” has the same meaning as the term in rule 0-10 under the Investment Company Act. Rule 0-10 defines the term as applied to management investment companies as two or more management companies (including series thereof) that (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either (A) have a common investment adviser or have investment advisers that are affiliated persons of each other, or (B) have a common administrator. 17 CFR 270.0-10(a)(1). See Inline XBRL Filing Release, at 3 n.1.

Inline XBRL Filing Release, at 54. Website posting is currently required by rule 405(g) and General Instruction C.3.(g) to Form N-1A.

Id., at 55.
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SC1:4694305v2
SEC Staff No-Action Letter Eases Board’s Burden in Reviewing Affiliated Transactions

By Lori L. Schneider, Fatima S. Sulaiman, Christopher R. Bellacicco

On October 12, 2018, the staff of the Division of Investment Management (“Staff”) of the U.S. Securities and Exchange Commission (“SEC”) issued a no-action letter to the Independent Directors Council (“IDC”) (“IDC Letter”) making it easier for fund boards to oversee affiliated transactions, such as cross-trades between funds managed by the same investment adviser. In the IDC Letter, the SEC stated that it would not recommend enforcement action for violations of Sections 10(f), 17(a), or 17(e) of the Investment Company Act of 1940, as amended (the “Act”) if a fund board receives from the fund’s chief compliance officer (“CCO”), no less frequently than quarterly, a written representation that any transactions effected in reliance on Rules 10f-3, 17a-7, or 17e-1 under the Act (“Affiliate Exemptive Rules”) complied with procedures adopted by the board pursuant to the relevant Affiliate Exemptive Rule, rather than the board itself making such compliance determinations and reviewing affiliated transaction details on a quarterly basis. The letter appears to be an outgrowth of a recent board outreach initiative by regulators that aims to review and reevaluate fund directors’ responsibilities under the federal securities laws.

Sections 10(f), 17(a), and 17(e) of the Act prohibit registered investment companies from engaging in certain transactions with affiliates. However, the SEC has adopted the Affiliate Exemptive Rules over the years to permit certain affiliated transactions, provided that a fund’s board, including a majority of its independent directors: (1) adopts, and amends as necessary, procedures that are reasonably designed to provide that the transactions comply with the requirements of the pertinent Affiliate Exemptive Rule; and (2) determines at least quarterly that the affiliated transactions made pursuant to the Affiliate Exemptive Rule during the preceding quarter complied with the relevant procedures adopted by the board.

In granting the no-action relief, the Staff acknowledged that since the adoption of the Affiliate Exemptive Rules, the SEC has adopted Rule 38a-1, which requires funds to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of federal securities laws and regulations, including the Affiliate Exemptive Rules. Rule 38a-1 also requires boards to approve the designation of a CCO who will be responsible for administering such policies and procedures.

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2 Independent directors are directors who are not considered “interested persons” as that term is defined under Section 2(a)(19) of the Act.
3 Subject to certain conditions, Rule 10f-3 exempts from the prohibitions of Section 10(f) purchases of securities by a fund from an affiliated underwriter in a securities offering; Rule 17a-7 exempts from the prohibitions of Section 17(a) cross-trades between affiliated funds and between fund and nonfund accounts affiliated solely by reason of having a common investment adviser; and Rule 17e-1 outlines the circumstances in which a commission, fee, or other remuneration received from a fund by an affiliated broker or an affiliate of an affiliated broker is “usual and customary” as required by Section 17(e).
4 Rule 38a-1(a)(1).
5 Rule 38a-1(a)(4).
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The Staff recognized the considerable responsibilities placed on directors as well as the prominent role of CCOs in handling the administrative aspects of a fund’s compliance program. As a result, the Staff agreed with the IDC’s reasoning that reviewing affiliated transactions to determine compliance with fund policies and procedures is more appropriately a CCO function, and this framework would be consistent with the SEC’s policy underlying Rule 38a-1. The Staff stated that allowing a board to rely on the written representation of the CCO rather than making its own determinations “would not change the board’s oversight role with respect to a fund’s overall compliance program.” Instead, it would allow directors to devote greater attention to “conflict of interest concerns” and whether engaging in affiliated transactions “is in the best interest of that fund and its shareholders,” rather than focusing on the day-to-day administrative features of a fund’s compliance program.

Notwithstanding Chair Jay Clayton’s recent statements “that all staff statements [including no-action letters] are nonbinding and create no enforceable legal rights or obligations of the [SEC] or other parties” and the statement in the IDC Letter clarifying that the “letter is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved its content,” we do expect funds and their boards will begin to rely on the letter and receive quarterly written representations from the CCO regarding compliance with the procedures adopted pursuant to the Affiliate Exemptive Rules in lieu of the board making quarterly determinations regarding compliance. Fund boards and CCOs that plan to rely on the IDC Letter should review existing fund procedures relating to the Affiliate Exemptive Rules to reflect the facts and conditions in the no-action letter. The IDC’s incoming letter notes that the CCO’s representation could be a part of the quarterly written report that many CCOs already provide to boards or could be a standalone document. Boards and their counsel should consider the appropriate details that will be included in the CCO’s representation, such as the types and number of transactions effected in reliance on each Affiliate Exemptive Rule during the quarter.

Revisiting Additional Director Duties under the Act

The no-action relief may signal further guidance from the SEC or the Staff on fund boards’ obligations under the Act and how they discharge those obligations. In October 2017, the IDC sent a letter to Dalia Blass, Director of the Division of Investment Management, highlighting the need to review fund directors’ responsibilities and recommending several revisions to specific director duties. The recommendations related to reassessing director responsibilities and governance requirements to address changes and developments in the industry, as well as eliminating “ritualistic requirements” that duplicate the work of the CCO.

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7 We note that the IDC Letter goes further than the letter previously issued to the IDC and Mutual Fund Directors Forum in 2010. The 2010 letter stated that fund boards must continue to make the quarterly determinations required by the Affiliate Exemptive Rules, although it acknowledged that such determinations could be made in reliance on summary reports from the CCO or other designated persons. Letter from Michael S. Diduk, Attorney-Adviser, Division of Investment Management, SEC, to Dorothy A. Berry, Independent Directors Council and Jameson A. Baxter, Mutual Fund Directors Forum (Nov. 2, 2010). The IDC Letter clarifies that the no-enforcement position in the letter may be relied upon notwithstanding any inconsistent statements in the 2010 letter.
9 Id. at Appendix B.
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Over the last year, Director Blass and the Staff have engaged in a “Board Outreach Initiative,” meeting with fund boards, counsel, and auditors in the industry to consider any regulatory changes that would improve the ability of fund boards to serve shareholders. The IDC Letter appears to be a positive result of this outreach effort.

Other areas of director responsibility that the IDC recommended in its October 2017 letter that the Staff reevaluate or bring to the attention of the SEC included:

- Adopting a rule permitting boards to delegate to the fund’s adviser the responsibility to determine fair value of securities, subject to the board’s oversight;
- Modernizing board responsibilities under Rule 12b-1 of the Act, such as the requirement that boards review Rule 12b-1 payments on a quarterly basis and reconsidering the relevance of factors listed in the Rule 12b-1 adopting release that boards should consider in determining whether to renew a distribution plan;
- Relieving boards of their responsibility under Rule 5b-3 to determine that each issuer of securities serving as collateral in certain repurchase agreements is able to meet its financial obligations and that the securities are sufficiently liquid;
- Modernizing Rule 17f-5 to allow directors to serve in an oversight role, rather than “be involved in the minutiae associated with the regular placement of foreign assets”;
- Eliminating the board approval requirement for fidelity bonds pursuant to Rule 17g-1, except in the case of joint bonds where there is potential for conflicts of interest among the insureds;
- Revising the requirement under Rule 18f-3 that boards make certain determinations in connection with expense allocation, so that fund accountants and fund administrators make such determinations rather than the board;
- Allowing fund service providers to set the time for computing a fund’s net asset value pursuant to Rule 22c-1, rather than requiring boards to do so;
- Adopting a rule allowing a fund to be exempted from the in-person meeting requirements of the Act if an unforeseen circumstance arises, so long as certain conditions are satisfied; and
- Adopting an exemptive rule allowing directors to be considered “independent” if they hold only a nonmaterial or de minimis interest in a fund’s unaffiliated subadvisers or their parent companies.

While it remains to be seen what further actions the Staff will take as it reassesses fund director responsibilities, the IDC Letter is a positive first step toward focusing the role of fund boards for the benefit of fund shareholders in a way that helps to clarify the board’s oversight role versus the role of fund management.

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11 Lancellotta, supra note 8, at Appendix B.
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